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Republic of Mozambique: First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility—Staff Report; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Mozambique

In the context of the first review under the three-year arrangement under the Poverty Reduction and Growth Facility with the Republic of Mozambique, the following documents have been released and are included in this package:

- the staff report for the first review under the three-year arrangement under the Poverty Reduction and Growth Facility, prepared by a staff team of the IMF, following discussions that ended on September 24, 2004, with the officials of Mozambique on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 28, 2005. 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.

- a staff statement of February 11, 2005 updating information on recent developments.

- a Press Release summarizing the views of the Executive Board as expressed during its February 11, 2005 discussion of the staff report that completed the review.

- a statement by the Executive Director for the Republic of Mozambique.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of the Republic of Mozambique*
Memorandum of Economic and Financial Policies by the authorities of the Republic of Mozambique*
*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF MOZAMBIQUE

First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility

Prepared by the African Department
(In consultation with other departments)

Approved by David Nellor and Anthony Boote

January 28, 2005

- On July 6, 2004, the Executive Board approved a new PRGF arrangement for Mozambique in an amount of SDR 11.36 million (10 percent of quota) to support the government's economic program for 2004-06. The discussions for the first review under the arrangement were conducted in Maputo on September 9-24, 2004, and were concluded in November and December 2004.
- The staff team comprised Mr. Di Tata (Head), Mr. Manoel, Ms. Dabán Sanchez, and Ms. Mendez (all AFR), and Mr. Joly (PDR). Mr. Ford (consultant, MFD) conducted a parallel visit to discuss steps to strengthen the balance sheet of the Bank of Mozambique (BM). Ms. Patel, Senior Advisor to the Executive Director for Mozambique, and Mr. Moll from the World Bank also participated in the discussions. The mission was assisted by Mr. Perone, the Fund Resident Representative in Maputo. The staff team met with the Prime Minister and Minister of Planning and Finance; the Ministers of Health, Industry and Trade, and Labor; the Governor of the BM; other senior government officials; and representatives of the donor community and the private sector.
- In approving the new PRGF arrangement, Executive Directors noted the broadly satisfactory economic performance of Mozambique during 2003 and the first months of 2004. Directors welcomed the government's program for 2004-06, which seeks to consolidate macroeconomic stability and address an important agenda of pending reforms. They encouraged the authorities to further strengthen revenue and closely monitor spending, enhance monetary control by allowing for greater exchange rate flexibility, and remove obstacles to private sector development.
- Performance relative to the program's main macroeconomic objectives in 2004 was satisfactory. Economic activity remained strong and inflation declined. The implementation of the fiscal program was affected, however, by a significant revenue shortfall, which is likely to have had an adverse impact on spending in some priority sectors. All the end-June 2004 quantitative performance criteria, as well as the structural performance criteria linked to the second disbursement under the arrangement, were observed. Performance with regards to the program's structural benchmarks, however, was mixed.
- Mozambique avails itself of the transitional arrangements under Article XIV, but has no Article XIV restrictions. It maintains, however, restrictions on the making of payments and transfers for current international transactions subject to Article VIII, as evidenced by (i) discretionary prior approval for remittances of family living expenses; (ii) authorization for the purchase of foreign exchange in excess of US$5,000 for certain current transactions; (iii) prohibition for the conversion of balances in nonresidents' domestic currency accounts into foreign currency or transfer abroad; and (iv) proof of performance of a service prior to authorizing its payment.

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EXECUTIVE SUMMARY

Mozambique's performance in 2004 relative to the main macroeconomic objectives of the PRGF-supported program was satisfactory. Real GDP growth is estimated to have remained strong at close to 8 percent, and inflation declined from 13.8 percent during 2003 to 9.1 percent in 2004, which is below the program's end-year target of 11 percent. All the quantitative performance criteria for end-June 2004, as well as the structural performance criteria linked to the second disbursement under the arrangement, were observed. Performance relative to the program's structural benchmarks, however, has been mixed, owing in part to capacity constraints and the political transition to a new administration.

The fiscal performance through September 2004 was adversely affected by a significant revenue shortfall. The government's domestic primary deficit is now projected at 3.6 percent of GDP in 2004 (3.3 percent in the program), as the revenue shortfall would be partially offset by lower spending, which might affect some priority sectors. Broad money growth declined from 19 percent in 2003 to 12 percent in September 2004. The still high level of lending rates (interest spreads have narrowed somewhat but still remain at 13-14 percent) has contributed to a slower than envisaged growth of credit to the private sector. The adoption of a more flexible exchange rate policy led to a nominal appreciation of the metical against the U.S. dollar of 20.8 percent during 2004.

The program for 2005 envisages slower growth of 7.3 percent and a further decline in inflation to 8.5 percent by year's end. The fiscal program seeks to increase revenue through improvements in tax administration and the expiration of some tax benefits, and to reduce the domestic primary deficit to 3.3 percent of GDP, with the view of providing appropriate room for credit to the private sector. The overall deficit after grants is projected to widen in 2005, owing to a substantial increase in capital outlays financed with concessional project loans and part of the proceeds from a signing fee paid by a Brazilian company for coal prospecting and exploration. Several steps are envisaged toward establishing a Central Revenue Authority by the end of the year and strengthening public expenditure management and fiscal transparency.

The program includes additional measures to improve liquidity sterilization, including through the introduction of foreign exchange auctions by end-February 2005. Further steps will also be taken to strengthen the balance sheet of the Bank of Mozambique, improve bank supervision, and move toward IFRS in the banking system. The current supervisory regime for the largest bank will be kept in place until approval of the bank's financial statements for 2004, and a full feasibility study on the divestment of the government's participation in the bank will be completed by end-June 2005.

Other structural measures include the submission to the assembly during the second half of 2005 of a new labor law aimed at increasing labor market flexibility and a new foreign exchange law to clarify existing regulations and practices. In addition, a PSIA study on land tenure regulations and their implications for accessing bank financing will be conducted during 2005 with donor support.

I. INTRODUCTION

1. **In the attached letter to the Managing Director dated January 24, 2005 (Appendix I)**, the Prime Minister and Minister of Planning and Finance and the Governor of the Bank of Mozambique request the completion of the first review under the current PRGF arrangement and the disbursement of the second loan under the arrangement in an amount of SDR 1.62 million (1.43 percent of quota). The memorandum of economic and financial policies (MEFP) attached to the letter describes the progress made under the program through September 2004, as well as the government's policies for 2005 (Appendix I, Attachment I). The completion of the review was delayed owing to the need for further discussions with the authorities on a revenue shortfall experienced in 2004, some modifications to the draft 2005 budget introduced after the review mission, and the macroeconomic implications of a contract on coal prospecting and exploration recently signed by the government with an international company. Relations with the Fund and the World Bank are discussed in Appendices II and III, respectively, and Statistical Issues in Appendix IV.

2. **Presidential and parliamentary elections were held on December 1-2, 2004, and the official results were announced on December 21**. Mr. Guebuza of the Frente de Libertação de Moçambique (FRELIMO, the ruling party) received 64 percent of the votes, compared to 32 percent for Mr. Dhlakama of the Resistência Nacional de Moçambique (RENAMO, the largest opposition party). The new administration is expected to take office in late January or early February 2005. Prior to the elections, the staff met with the presidential candidates of both parties, who stressed their commitment to macroeconomic stability and the current orientation of economic policies.

3. **In September 2004, the World Bank approved the first of a series of Poverty Reduction Support Credits (PRSCs) in an amount of US$60 million to support institutional and policy reforms**. Following a PSIA study financed by the United Kingdom Department for International Development (DFID) on the effects of increasing specific fuel taxes, the World Bank completed recently another PSIA on the impact of primary schooling fees.[1]

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[1] A description of the PSIA on specific fuel taxes is presented in IMF Country Report No. 03/288, Box 2. The PSIA on schooling fees concludes that a reduction or abolition of fees could mitigate the problem of low attendance and completion rates in primary education, but that other factors have a more decisive impact on these indicators.

II. Recent Economic Developments and Performance Under the PRGF-Supported Program

A. Macroeconomic Performance

4. **The program supported by the PRGF arrangement aims at consolidating macroeconomic stability and deepening structural reforms in order to sustain growth, promote employment creation, and further reduce poverty.** The program seeks to address a number of challenges, including the need to strengthen revenue and improve expenditure efficiency; enhance monetary and exchange rate management; deal with vulnerabilities in the banking system; and remove obstacles to private sector development.

5. **Performance relative to the program's main macroeconomic objectives in 2004 was satisfactory.** Economic activity remained strong in the first half of the year, reflecting MOZAL II (the expansion of the aluminum smelter) and the gas pipeline connecting Mozambique with South Africa coming into full operation, and a significant expansion in manufacturing, services, and transport and telecommunications. Real GDP growth is now estimated at close to 8 percent for the year as a whole, compared with 8.4 percent in the program, owing to slower activity in the construction sector (Table 1 and Figure 1). Inflation declined from 13.8 percent during 2003 to 9.1 percent in 2004, which is below the program's end-year target of 11 percent. All the quantitative performance criteria for end-June 2004, as well as the structural performance criteria linked to the second disbursement under the arrangement, were observed (Appendix I, Attachment I, Table 1).

6. **The fiscal performance through September 2004 was adversely affected, however, by a significant revenue shortfall relative to the program's projections.** Receipts from most taxes, with the exception of those on petroleum products, turned out lower than programmed owing to several factors, including higher-than-envisaged reimbursements of the value-added tax related to the megaprojects, delays incurred by some companies in complying with the payments calendar under the new corporate income tax code, and the impact of the appreciation of the metical (see below) on customs collections.[2] The revenue shortfall (equivalent to 0.8 percent of annual GDP) was offset by lower spending on goods and services and locally financed capital outlays, which is likely to have affected some priority sectors, and the indicative target on the domestic primary deficit through end-September was missed by a very small margin. At the same time, the indicative target on the wage bill was exceeded because the government decided to retain some contractual personnel employed last year in the education sector (Table 2).

7. **Broad money growth declined from 19 percent in 2003 to 12 percent in September 2004, reflecting in part the impact of the appreciation of the currency on the foreign currency component of private sector deposits (Table 3)**. Although the end-June 2004 quantitative performance criteria and end-September indicative targets on the net

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[2] The authorities have continued to adjust domestic petroleum prices on a monthly basis in line with developments in import prices, and they have increased specific fuel taxes on a quarterly basis in line with inflation during the previous three months.

domestic assets (NDA) and net international reserves (NIR) of the central bank were observed, the indicative targets for base money were exceeded because of an underestimation of the impact of modifications in reserve requirements (see paragraph 8). Commercial banks' lending rates declined from about 28 percent at end-2003 to 24 ¼ percent at end-November 2004, in line with the drop in inflation. Interest spreads have narrowed somewhat, but they still remain high at 13-14 percent (Figure 3).[3] Credit to the private sector has continued to increase at a slow pace.

8. **In recent months, the central bank has taken some steps to improve monetary management.** In particular, the authorities have increased the use of foreign exchange sales to sterilize excess liquidity, following large placements of domestic monetary instruments during the first half of the year.[4] This led to a nominal appreciation of the metical against the U.S. dollar of 20.8 percent during 2004. Also, the foreign exchange function of the Foreign Department of the BM has been transferred to the Markets Department, which will contribute to a better coordination of operations. Moreover, in late June 2004 the authorities broadened the application of reserve requirements to nonresident deposits and escrow deposits.

9. **The balance of payments continued to reflect developments in the megaprojects during the first half of 2004, with the trade deficit declining by about one-third.**[5] Exports were almost 65 percent higher than in the same period of the previous year, reflecting the initiation of operations of MOZAL II in late 2003 and the start of gas exports (Box 1). Imports increased by about 18 percent boosted by MOZAL II, the increase in oil prices, and the appreciation of the currency. Foreign direct investment, other capital inflows, and program assistance have been significantly larger than expected, resulting in a reserve accumulation of US$85 million through end-October 2004, well above the program's target for the year.[6] The metical appreciated by 14 percent in real effective terms over the year ended September 2004.

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[3] A number of factors of structural nature contribute to the persistence of wide spreads, including the relatively large share of nonperforming loans, the absence of efficient judicial procedures to facilitate loan recovery, and difficulties in obtaining and using collateral.

[4] As a result of heavy reliance on sterilization operations with central bank bills during the first half of the year, the operating losses of the central bank are projected at 1 percent of GDP in 2004.

[5] The trade statistics have been revised significantly, owing to a widening of data coverage and corrections of past data-processing problems.

[6] The actual international reserve figures for end-2003 and the quarterly program targets for end-June, end-September, and end-December 2004 were adjusted downward by removing from reserve assets the end-2003 amount corresponding to certain deposits of the central bank with foreign correspondents that are earmarked for specific imports. The decision to exclude these deposits from foreign assets is based on a recommendation made by FIN last June in the context of a full safeguards assessment mission.

Box 1: The Impact of Megaprojects on the Balance of Payments

In recent years, Mozambique's balance of payments has been affected considerably by the development of megaprojects. Before MOZAL started operations in 2000, exports consisted mostly of a few agricultural and fishing products, with prawns constituting the main export item.[1] In 2003, MOZAL's exports accounted for more than 50 percent of total merchandise exports and seven times prawn exports, which remain the main "traditional" export product. With the doubling of MOZAL's production and export capacity and the completion of the gas pipeline to South Africa (referred to as SASOL), megaproject exports will make up about 75 percent of total merchandise exports in 2004.

Merchandise imports have also been affected on various counts. Overall, more than 20 percent of total merchandise imports are related to the megaprojects. While the impact on imports of the gas pipeline was essentially limited to the construction phase, MOZAL's imports (e.g., energy and bauxite) have remained substantial in the operation phase. Although services imports are more difficult to break down precisely, about 40 percent is estimated to be related to megaprojects. This share would increase in the future, as interest and dividend payments to foreign shareholders are expected to rise. The capital account has also been substantially affected, since most of the financing for the megaprojects has been in the form of foreign borrowing and direct investment.

A titanium ore megaproject was launched in 2004 that is expected to become operational in about two years. This project will contribute to higher imports and capital inflows over the horizon of the current PRGF arrangement. In addition, the feasibility study of a coal mine project will begin in 2005 (see paragraph 13).

Summary impact of megaprojects on Mozambique's balance of payments, 2003-04

	2003 (Est.)		2004 (Proj.)	
	Millions of U.S. dollars	In percent 1/	Millions of U.S. dollars	In percent 1/
Exports of goods	681	65	1094	74
Imports of goods (cif)	386	22	433	22
Private imports of services	228	44	267	39
Private foreign borrowing	62	39	0	0
Private amortization payments	66	47	104	60
Direct investment	234	68	164	45

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

1/ In percent of the total for the corresponding item in the balance of payments.

[1] This excludes electricity. Thanks to the large Cahora-Bassa dam, Mozambique produces large quantities of hydro-power. Most of the production is exported to South Africa, and then partly re-imported to cover domestic demand.

B. Structural Reforms and Poverty Reduction

10. **As noted above, the three structural performance criteria linked to the second disbursement under the arrangement were observed.** In June 2004, the authorities submitted to the assembly a draft general tax law, and in July, they strengthened the balance sheet of the BM by shifting to the government a large part of the bank's external liabilities. Moreover, the supervisory regime for the Banco Internacional de Moçambique (BIM), the

largest commercial bank in the country, has been kept in place, with monthly information showing that the bank remains profitable and continues to comply with prudential requirements (Appendix I, Attachment 1, Table 2).

11. **Performance with regards to the program's structural benchmarks, however, has been mixed, owing in part to capacity constraints.** In early August 2004, the authorities submitted to the assembly a draft law creating the Central Revenue Authority; and in early November they partially implemented a new financial administration system (SISTAFE) in the Ministry of Planning and Finance (MPF). However, (i) the preparation of the quarterly budget execution report based on the e-SISTAFE has been postponed from the third quarter of 2004 to the first quarter of 2005; (ii) the BM has adopted measures to strengthen one small bank but is still studying the resolution strategy for a small cooperative; and (iii) the adoption of a timetable to move toward International Financial Reporting Standards (IFRS) in the banking system has been postponed, owing to administrative delays (beyond the authorities' control) in concluding the reviews of three large banks that are being conducted with donor support.

12. **Progress in other areas where the program had no formal conditionality, such as land tenure regulations and the judicial system, has been limited (see paragraph 36 below).** In addition, the regulations of the anti-money laundering law were issued in August 2004, but the establishment of a financial investigations unit (part of a structural benchmark for end-December 2004) will take longer than originally envisaged due to the possible need for additional legislation.

13. **Recently, the government received a significant amount of resources corresponding to a contract signed with a Brazilian company.** In November 2004, the Companhia Vale do Rio Doce (CVRD) paid a fee amounting to US$123 million (2.2 percent of GDP) following the signing of a contract with the government for the rights to conduct coal prospecting and exploration in the province of Tete.[7] CVRD will now carry out a feasibility study, which is expected to take two years.

14. **The PARPA (Mozambique's PRSP) envisages a reduction in the proportion of the population living below the poverty line from nearly 70 percent in 1997 to 60 percent in 2005 and 50 percent in 2010.** A National Household Survey conducted in 2002/03 indicates that the proportion of the population living in absolute poverty dropped to 54 percent in 2002/03, or below the PARPA target for 2005.[8] Notwithstanding these results, the World Bank estimates that the MDGs on gender equality, access to safe water in urban

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[7] The bidding took place in October 2004 with the participation of four pre-qualified international companies.

[8] See Box 1 in the Request for a New Three-Year Arrangement under the Poverty Reduction and Growth Facility (IMF Country Report No. 04/342).

areas, child mortality, maternal mortality, and malaria, which are more ambitious than the PARPA objectives, are unlikely to be met. Meeting these goals would require even higher levels of donor support and substantial improvements in absorptive capacity in several areas.

15. **Spending on the PARPA priority sectors rose from about 55 percent of primary expenditure in the first half of 2003 to 63 percent in the same period of 2004 (a nominal increase of 33 percent).**[9] Spending on the education sector increased markedly during this period, reflecting the hiring of new teachers and the construction of new schools. There was, however, a significant budgetary under execution in the areas of health, roads, and water and sanitation.

16. **The authorities indicated that the third annual report on the implementation of the PARPA would be finalized in late February 2005, before the discussions on the second review under the program.** Also, a new full PARPA covering the period 2006–10 will be completed by February 2006. Efforts have continued in recent months to improve donor coordination in the context of a Direct Budget Support Group comprising 15 donors and the World Bank (the G-16) (Box 2).

III. The Program for 2005

17. **Following the coming on line of MOZAL II and the gas pipeline in 2004, real GDP growth is projected to slow to 7.3 percent in 2005; inflation is targeted to decline further to 8.5 percent by year's end (see Table 1).** During the program discussions, the authorities indicated that some structural reforms involving the approval of legislation (such as a revised labor code and a new foreign exchange law) were likely to be delayed until the second half of 2005 owing to the political transition, including in particular the time required to establish the new assembly.

A. Fiscal Policy

18. **The government's domestic primary deficit for 2004 is now projected at 3.6 percent of GDP (3.3 percent in the program)** (see Table 2 and Figure 4). Total revenue is expected to have declined to 14.0 percent of GDP in 2004, compared with 14.6 percent of GDP in the program, with the revenue shortfall being partially offset by lower spending on goods and services and locally financed capital outlays. The authorities were of the view that the revised revenue target for 2004 was achievable, and they were confident that the delays in collecting the corporate income tax would be normalized, to a large extent, during the last

[9] This compares with 65 percent envisaged in the PARPA for the whole year 2004.

Box 2. Coordination with Donors and Other International Organizations

Significant progress has been made in recent years in coordinating the work of the Mozambique's donor community, and the Fund has participated actively in this process. Donor coordination has taken place through three different modalities: the Direct Budget Support (DBS) Group, program cooperation, and the Development Partner Group (DPG).

1. **The DBS Group:** The DBS Group has expanded rapidly in recent years and now comprises 16 donors (the G-16), including the World Bank. In April 2004, following a Joint Review of the implementation of the PARPA, the G-16 and the government agreed on a Memorandum of Understanding that sets out in detail the arrangements for budgetary support. A specific feature of these arrangements is the agreement on a Performance Assessment Framework (PAF) consisting of a set of policies, actions, and output indicators with a three-year horizon, which are linked to broader commitments under the PARPA. Performance under the PAF is assessed through semiannual joint reviews.
2. **Program cooperation:** Sectoral programs focus on agriculture, health, education, roads, and rural water. In some cases, there are common funds that are managed through so-called sector wide assistance programs. In addition, there is a Public Sector Reform group, as well as groups that monitor the implementation of the SISTAFE and tax reform.
3. **The Development Partner Group (DPG):** The DPG consists of the heads of missions of all bilateral donors, the UN, the Fund, and the World Bank. The group meets monthly and acts as an information-sharing vehicle. Subgroups have also been created to follow up on ensuing recommendations and facilitate the preparation of Consultative Group meetings.

The Fund's coordination with donors takes place primarily through the IMF Office in Maputo and the missions that regularly visit the country. The IMF office consists of the Resident Representative (RR) and a locally hired expatriate Technical Assistant Coordinator (TAC). While the Fund is not a member of the G-16, it is given formal observer status at all the meetings of the group and participates actively in the Joint Reviews to help coordinate the initiatives of the donors with the PRGF. The RR also attends monthly meetings of the sectoral working groups in the areas of private sector development and judicial reform. Moreover, he participates in the monthly meetings of the DPG, where he provides information on macroeconomic developments and the work of the Fund in Mozambique. In addition, both the RR (as co-chair of the respective steering committees) and the TAC work closely with donors in coordinating the implementation of tax reform program and the SISTAFE.

In addition to the work of the RR office, AFR missions meet regularly with representatives of the donor community during their visits to Maputo. During the recent PRGF review mission, several meetings were held to exchange views about macroeconomic and structural issues and develop a common approach in overlapping areas. Moreover, AFR missions debrief donors at the conclusion of each visit, with the participation of government officials. Technical assistance missions also meet with donors to coordinate their activities.

quarter of 2004. Based on developments through September, the wage bill would amount to 7.5 percent of GDP in 2004, or slightly higher than programmed. The overall deficit after grants, which is now projected at 4.9 percent of GDP, is expected to have been more than covered by net external concessional borrowing. The proceeds from the CVRD payment for coal prospecting and exploration were deposited in their entirety in a government account abroad (with the central bank acting as agent), with the view of establishing a savings fund.

19. **The fiscal program for 2005 envisages a reduction in the domestic primary deficit to 3.3 percent of GDP, with the view of limiting resort to domestic financing of the government.** The overall deficit after grants would rise to 7.0 percent of GDP in 2005, owing to a substantial increase in capital expenditure financed with concessional project loans and part of the proceeds from the contract on coal prospecting and exploration. The deficit is expected to be mostly covered by net concessional external borrowing, with domestic financing projected at 1.0 percent of GDP.[10] The increase in project financing reflects higher disbursements from the World Bank and from the African Development Bank for water management. In addition, a portion of the proceeds from the CVRD payment (US$24 million in 2005; US$16 million in 2006; and US$9 million in 2007) will be used to finance a water project and the construction of several bridges.

20. **Total revenue is expected to increase to 14.9 percent of GDP in 2005 on account of** (i) the incorporation into the budget of the own generated revenues of districts and some line ministries (0.4 percent of GDP); (ii) the introduction of new computerized systems to support tax collection early in the year; (iii) a better performance of the corporate income tax, owing to the expiration of tax benefits applied to some projects and improvements in collection as corporations become more familiar with the new system; and (iv) higher receipts of royalties from the megaprojects. **Noninterest current expenditure** would rise from 14.4 percent of GDP in 2004 to 14.8 percent in 2005 reflecting the incorporation of extrabudgetary expenditures financed with the revenue from districts and line ministries referred to above.[11] The wage bill, excluding outlays not previously included in the budget, is projected to decline to 7.4 percent of GDP in 2005, notwithstanding an increase of 10,000 in personnel, mostly in the PARPA priority sectors. To that end, the average general wage increase for government employees, effective April 1, 2005, will be limited 6.5 percent. Spending on the priority sectors is projected to increase from 65 percent of total primary spending in 2004 to 67.3 percent in 2005.

21. **The program for 2005 envisages several steps aimed at establishing a Central Revenue Authority (CRA) by end-2005.** In this regard, the authorities intend to issue the internal regulations and the statute for the staff of the internal revenue administration (DGI) by end-April 2005 (structural benchmark), as well as the regulations of the new general tax law and the law of creation of the CRA during the second half of 2005. The authorities will

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[10] The government's domestic debt is small. Under the program, it is projected to decline from 4.8 percent of GDP at end-2003 to 2-2½ percent of GDP in 2004-05.

[11] Moreover, the budgetary projections for wages and goods and services include expenditures previously classified as transfers to districts.

also (i) implement modern procedures and regulations for tax audits by end-June 2005; and (ii) broaden the scope of a new taxpayer registry system introduced in April 2004.

22. **Regarding public expenditure management,** during 2005 the e-SISTAFE will be rolled out to the line ministries, starting with the Ministry of Education by end-June 2005 (structural benchmark).

B. Monetary and Exchange Rate Policies

23. **Broad money growth is estimated at 12 percent for 2004 as a whole, or lower than in the program's projection.** Taking into account the reserve accumulation registered so far this year, NIR are estimated to increase by US$75 million during 2004, compared with zero change envisaged in the program (see Table 3).

24. **Assuming a slight increase in velocity, the monetary program for 2005 seeks to contain broad money growth at 14.5 percent.** Following the increase registered in 2004, NIR are programmed to decline by US$25 million in 2005, with the import coverage of gross reserves projected at 4.3 months by year's end. Based on the fiscal program described above, the monetary program for 2005 provides room for an increase in credit to the private sector broadly in line with nominal GDP.

25. **Further measures will be adopted during 2005 to improve liquidity sterilization by using sales of foreign exchange.** A foreign exchange auction system will be put in place by end-February 2005 with technical support from a Fund expert (structural benchmark), and the central bank will seek to limit intervention in the foreign exchange market to achieving the international reserve targets.

26. **The program also includes measures to strengthen the balance sheet of the central bank.** For that purpose, the draft budget for 2005 envisages the issuance of Mt 1.5 trillion in government securities at market interest rates, which will be transferred to the BM in order to improve its financial position before end-June 2005 (structural performance criterion). This step will be followed by further issuances of securities in 2006 and 2007. Moreover, the central bank intends to review its administrative expenses.

C. Financial Sector Policies

27. **Further steps were taken during 2004 to strengthen bank supervision.** Following the approval of a new Financial Institutions Law last May, the central bank completed the preparation of the regulations of the law and a regulatory framework for microfinance activities. With the support of a Fund expert, progress has also been made in drafting an inspection manual, preparing models for the presentation of consolidated financial statements, and training and increasing the staff of the Department of Banking Supervision.

28. **The authorities remain committed to implementing International Financial Reporting Standards (IFRS) in the banking system with technical support from the World Bank.** Following the completion of the ongoing reviews of three large banks, by end-February 2005 they will develop timetables for adopting IFRS and strengthening loan-loss provisions (structural benchmark).[12]

29. **Regarding BIM, the current supervisory regime will be kept in place until approval of the bank's financial statements for 2004 by the external auditors (continuous structural performance criterion).** In addition, the authorities are working on a feasibility study on the divestment of the government's participation in the bank (structural performance criterion linked to the third disbursement under the arrangement). As a first step, a short strategy document outlining the envisaged divestiture process will be finalized in the coming weeks. The full feasibility study, however, would be completed by end-June 2005, rather than end-2004, as the authorities recently requested technical support from the World Bank.

D. External Sector Policies

30. **The external current account deficit after grants is projected to widen from almost 7 percent of GDP in 2004 to about 10.5 percent in 2005** (see Figure 4). Following the sharp increase registered in 2004, export growth would slow to 4 percent in 2005. At the same time, imports would continue to grow at a strong pace reflecting a substantial increase in project imports, including those related to a titanium ore project. The services account would deteriorate significantly because of a large increase in dividend payments to the megaproject's foreign shareholders. The current account deficit is expected to be almost fully covered by large foreign direct investment flows and private borrowing associated in particular with the titanium project. Aid flows (grants and concessional loans) are projected to increase from US$755 million in 2004 to US$935 million in 2005 (14.0 percent of GDP). Based on the program described above, the ratio of the net present value of the public external debt to exports would hover around 90 percent in 2004-06 (Tables 4 and 5).[13]

31. **Notwithstanding the recent significant real appreciation of the metical, the currency does not appear to be misaligned.** Over the past four years, the metical registered, overall, a real effective depreciation of 8 percent. Moreover, the trade statistics show that non-megaproject exports grew at a slower but still significant pace in early 2004.[14]

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[12] The average capital adequacy ratio for the banking system was estimated at 17 percent at end-2003. All banking institutions are in compliance with the minimum regulatory requirement, but the net worth position of a small cooperative needs to be strengthened.

[13] A debt sustainability analysis is presented in IMF Country Report No. 04/50, Appendix IV.

[14] Traditional export growth declined from 6.4 percent in 2003 to 4.6 percent in the first half of 2004.

The authorities recognized the possible adverse effects of the real appreciation on external competitiveness, but they agreed with the staff that, to a large extent, the recent real appreciation appears to reflect a change in fundamentals related to the unavoidable impact of increased capital inflows and continued large external assistance flows. Moreover, the authorities were of the view that the current policy allowing for greater exchange rate flexibility was necessary to lower inflation and reduce reliance on monetary sterilization with domestic debt instruments. Looking forward, the best response to the challenge posed by the real appreciation of the currency is to deepen structural reforms, particularly by removing obstacles to private sector development.

32. **No significant changes in the exchange and trade system are expected to take place in 2005**. The central bank is preparing a new foreign exchange law to clarify the existing regulations and practices, but the draft will not be submitted to the assembly until the second half of 2005. The authorities indicated that, following approval of this legislation and issuance of certain regulations, they intended to accept the obligations under Article VIII of the Fund's Articles of Agreement. Regarding the trade system, they reiterated their commitment to lowering the top import tariff rate applicable to all trading partners from 25 to 20 percent in 2006.

33. **Mozambique has concluded bilateral debt relief agreements under the enhanced HIPC Initiative with 10 out of 12 Paris Club creditors, but progress with non-Paris Club creditors continues to be limited.**[15] The authorities said that they would continue with efforts to finalize the remaining agreements with Japan and Portugal and reach agreements on comparable terms with non-Paris Club creditors.[16] A Consultative Group meeting to seek donor support for the government's economic and structural reform program is expected to be convened by the new administration during the first half of 2005.

[15] Recently, the government signed a bilateral agreement with Brazil that involves the cancellation of 95 percent of the debt (amounting to US$330 million) and the rescheduling of the remaining 5 percent over 23 years. The authorities indicated that the bilateral debt relief agreements with Japan and Portugal had not yet been signed owing to administrative delays and the time required by the debt reconciliation process with Japan, which has already been completed. In November 2003, Japan indicated its intention to provide 100 percent cancellation of its debt. The authorities have informed the staff that significant progress was made recently in the negotiations with Portugal. The share of the debt with these two countries in the total Paris Club debt (before the completion point) was 14 percent.

[16] Regarding non-Paris Club official creditors, negotiations have been completed with China and Kuwait. Moreover, the government is working on the details of a proposal for reducing its commercial debt through the IDA Debt Reduction Facility.

E. Other Structural Reforms and Governance Issues

34. **The staff discussed with the authorities the progress being made toward removing obstacles to private sector development.** Discussions focused on measures aimed at (i) lowering the cost of doing business; (ii) modifying land tenure regulations to facilitate the use of land as bank collateral; and (iii) reforming the judicial system. In addition, the staff reviewed recent developments in the areas of public sector reform and governance.

35. **The authorities have taken some steps to lower the cost of doing business.** Following the issuance of new regulations to simplify inspection procedures earlier this year, the government established one stop shops for business registration in three locations and approved a decree streamlining the licensing of commercial activities. In addition, the procedures for hiring expatriates have been simplified, and the government has recently approved the terms of reference for the preparation of a revised labor law that will seek to increase labor market flexibility by reducing retrenchment costs and facilitating temporary employment. The draft of the law is expected to be submitted to the assembly during the second half of 2005, after consultation with interested parties.

36. **Little progress has been made, however, on land tenure regulations and judicial reform.** The authorities indicated that the approval of a draft decree to strengthen property rights in urban areas had been postponed in light of the need to achieve a broad political consensus, given the sensitive nature of the issues involved. A PSIA study on land tenure regulations and their implications for accessing bank financing will be conducted in 2005 with donor support. **In the judicial system,** the reform process has been affected by the lack of material and human resources. An anti-corruption law was approved recently, and the government is now working on preparing the regulations of the law. Other important pieces of legislation, however, are still being considered by the Council of Ministers or the assembly. Early this year, the government launched a National Survey on Governance and Corruption, the results of which are expected to be published in the near future.

37. **Implementation of the long-term public reform program supported by the World Bank continues as planned.** The functional analysis of six major ministries has been completed, and studies to determine the appropriate size of the public sector and reform the wage system are under preparation.

F. Program Monitoring and Risks, Safeguards Assessment, and Statistical Issues

38. **Implementation of the program during 2005 will continue to be monitored by reference to semiannual quantitative performance criteria and indicative targets, as well as relevant structural performance criteria and benchmarks**, as specified in Tables 1 and 3 of the MEFP, with supporting definitions and elaborations contained in the Technical Memorandum of Understanding (TMU) (Appendix I, Attachment II). An indicative target consisting of semiannual floors on the resources in the savings fund has been added to monitor the use of the proceeds from the signing fee for coal prospecting and exploration.

The second review under the arrangement will be completed by the Executive Board no later than end-June 2005 based on the quantitative performance criteria and indicative targets for end-December 2004 and the structural performance criteria and benchmarks through end-April 2005. The third review under the arrangement will take place no later than end-November 2005 based on the end-June 2005 quantitative performance criteria and structural performance criteria and benchmarks, and other structural performance criteria to be agreed at the time of the second review.

39. **Main risks to the program** include the possibility of a weaker-than-envisaged revenue performance, which would affect the government's poverty reduction objectives; shortfalls in private capital inflows; and delays in implementing structural reforms associated with the political transition. The second review under the program will pay particular attention to these issues.

40. **A safeguards assessment of the BM conducted by a FIN mission in June 2004 found several weaknesses in the areas of financial reporting, internal audit, and the internal control system.** In particular, the assessment noted vulnerabilities in the procedures related to data reporting to the Fund. The BM has taken several actions to address these weaknesses, with technical support from STA. Specifically, (i) updated procedures for converting balance sheet data to the monetary data reported to the Fund have been established; and (ii) starting end-November 2004 the BM began to complete all reconciliations and necessary adjustments on a monthly basis so that the balances in its accounting records match those confirmed by the correspondents, external managers, and other third parties. Among other measures, by end-February 2005 the BM will adopt a firm timetable for implementing IFRS.

41. **Mozambique's statistical system presents several deficiencies that hinder policy implementation and the surveillance of economic developments.** Significant improvements are still necessary in the national accounts, the monetary data, the balance of payments, and the public finance statistics. The authorities indicated that efforts will continue in these areas with technical support from STA and bilateral donors. In this regard, by end-June 2005 the National Statistical Institute (INE) will compile and disseminate preliminary data on the 2004 GDP and will publish a revision policy for compiling and disseminating final national accounts data (structural benchmark). Moreover, INE is expected to finalize a labor force survey by September 2005 that will provide information about unemployment. Staff also stressed the need for timeliness in the transmission to the Fund of information critical to the program. In this regard, the completion of this review was delayed by lack of timely consultation with the staff regarding the revisions to the 2005 budget and the concession on coal prospecting and exploration.

IV. Staff Appraisal

42. **Performance relative to the program's macroeconomic objectives in 2004 continued to be satisfactory.** Real GDP growth remained strong, inflation declined, and the international reserve position was further strengthened. Advances were also made in

implementing structural reforms, notwithstanding some delays related to the political transition and capacity constraints, particularly in the areas of judicial reform and land tenure regulations. All the end-June 2004 quantitative performance criteria, as well as the structural performance criteria linked to the second disbursement under the arrangement, were observed.

43. **The fiscal performance through end-September 2004 was hindered by a significant revenue shortfall** related to a number of factors, including delays by companies in complying with the new corporate income tax, higher VAT reimbursements, and lower customs revenue. The domestic primary deficit through September did not deviate significantly from the program because the revenue shortfall was largely offset by lower nonwage spending. The revenue shortfall gives rise to serious concerns, however, as it is likely to have affected adversely the PARPA priority sectors.

44. **The fiscal program for 2005 seeks to reverse the revenue shortfall experienced this year in order to strengthen the domestic primary balance while providing adequate resources for the priority sectors.** Achieving the program's targets requires decisive action to strengthen tax enforcement, as well as firm discipline to control nonwage expenditure and keep the average general wage increase for government employees below projected inflation. Efforts are also necessary to ensure that the use of the proceeds from the signing fee for coal prospecting and exploration is fully transparent and is limited to the amount envisaged in the program. In addition, it will be important to implement in a timely fashion the steps required to establish the Central Revenue Authority by end-2005.

45. **Following the recent partial implementation of the new financial administration system in the MPF, further measures are envisaged in 2005 to strengthen public expenditure management and fiscal transparency.** In this regard, it is essential to adhere to the timetable for rolling out the SISTAFE to the line ministries and to continue broadening the coverage of the budget by incorporating extrabudgetary revenues and expenditures. Moreover, efforts should be intensified to restructure the major ministries and design an appropriate evaluation system for government employees in the context of the public sector reform program supported by the World Bank.

46. **The BM adopted recently several steps to enhance monetary management and increase exchange rate flexibility that are bearing fruit in terms of lower inflation.** Looking ahead, additional measures are necessary to improve liquidity sterilization through sales of foreign exchange, including by introducing foreign exchange auctions early next year. Moreover, the authorities should move ahead vigorously with the measures envisaged in the program to strengthen the balance sheet of the BM and reduce its operating losses, and to address the weaknesses identified by the recent safeguards assessment.

47. **In the financial system, the largest bank remains profitable and continues to comply with prudential requirements, and the authorities are working on a feasibility study on the divestment of the government's participation with technical support from the World Bank.** Moreover, the diagnostic reviews of three large banks will be completed

shortly, which will permit developing a timetable to move toward IFRS and strengthen loan loss provisions. In the period ahead, further steps are required to address remaining vulnerabilities in some small institutions and move toward an effective consolidated supervision.

48. **The significant real effective appreciation experienced by the metical over the last year reflects, to a large extent, the unavoidable impact of increased private capital inflows and continued large external assistance flows.** In these circumstances, the staff believes that the best way to enhance external competitiveness is by addressing the country's structural problems, including existing obstacles to private sector development. The authorities are also encouraged to clarify and improve the existing foreign exchange legislation in the context of the new foreign exchange law, and to eliminate remaining restrictions on the making of payments and transfers for current international transactions.

49. **The government has made some efforts to reduce the cost of doing business in Mozambique, including by streamlining regulations and simplifying procedures for hiring expatriates.** Looking forward, it would be important to press ahead with the preparation of the new labor law in order to increase labor market flexibility.

50. **The new administration should proceed vigorously with judicial reform and redouble efforts to achieve a consensus on measures to strengthen property rights and modify land tenure regulations.** These reforms are essential to strengthen the enforceability of contracts, stimulate investment, and facilitate access to credit by using land as bank collateral. In addition, prompt establishment of a financial investigations unit is necessary to improve the coordination of anti-money laundering activities.

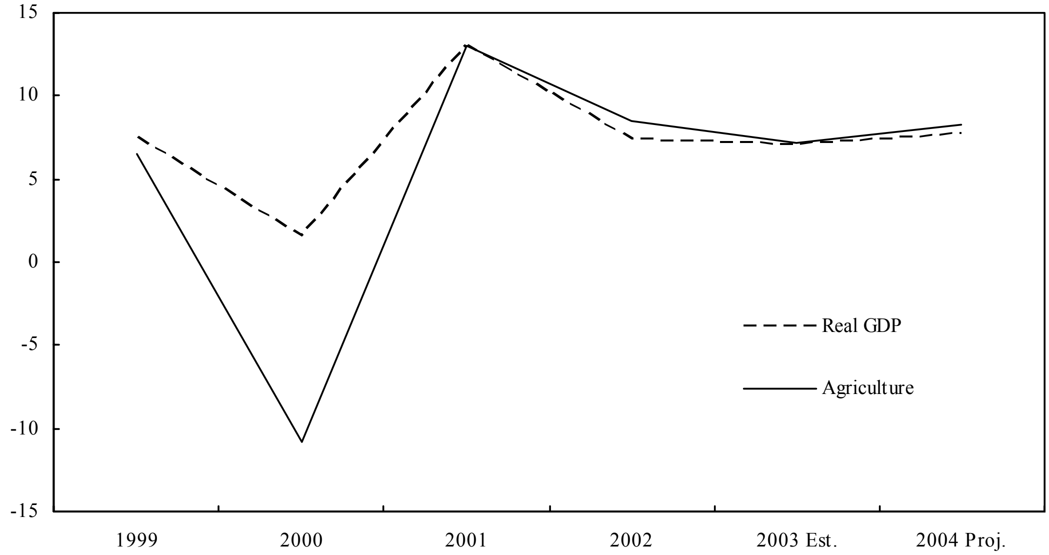
51. **Limited progress has been made in recent months on the external debt negotiations.** The staff encourages the authorities and Mozambique's external creditors to complete as soon as possible the remaining agreements with Paris Club creditors and reach agreements with non-Paris Club creditors on comparable terms.

52. **A determined effort is required to address a number of important statistical weaknesses that hinder policy implementation and economic surveillance.** Moreover, it is important to improve timeliness in the transmission to the Fund of information relevant to the program. The labor force survey being conducted by INE is a welcome step to obtain much needed information on unemployment.

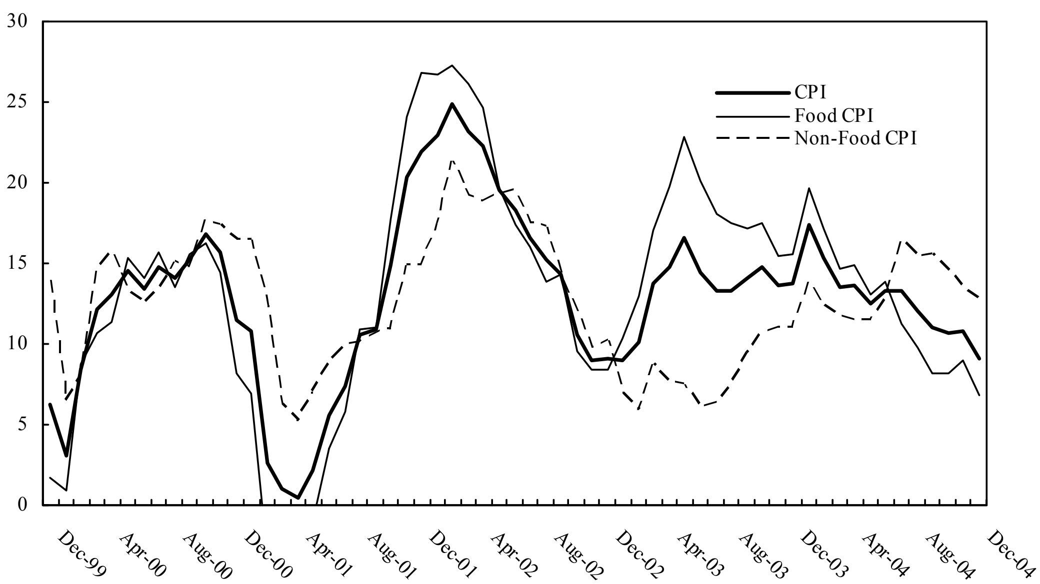
53. In light of Mozambique's broadly satisfactory performance under the PRGF-supported program in 2004 and the policies envisaged under the 2005 program, the staff recommends the completion of the first review under the PRGF arrangement.

Figure 1. Mozambique: Real Growth Rates and Inflation

Real Growth Rates, 1999 - 2004 (Proj.)
(In percent)



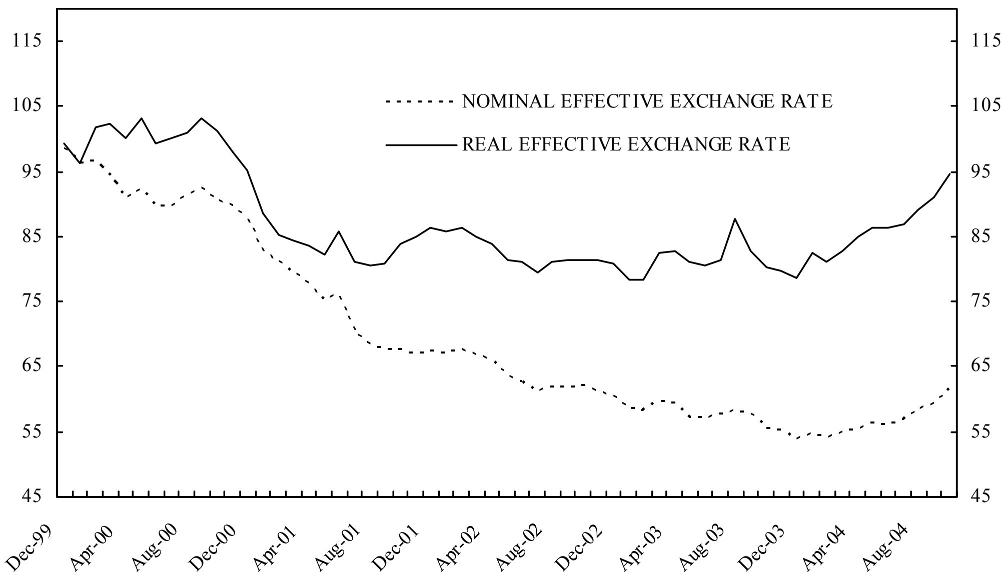
Inflation Rates (twelve-month), December 1999 - December 2004
(In percent)



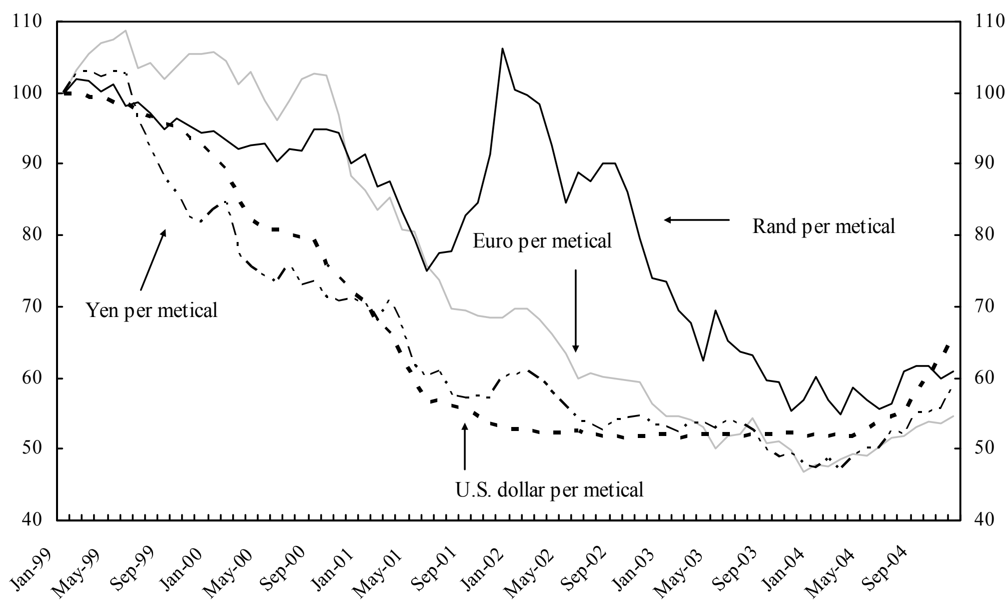
Sources: Mozambican authorities and staff estimates.

Figure 2. Mozambique: Exchange Rates

Effective Exchange Rate, January 1999 - October 2004
(Jan 1999 = 100)

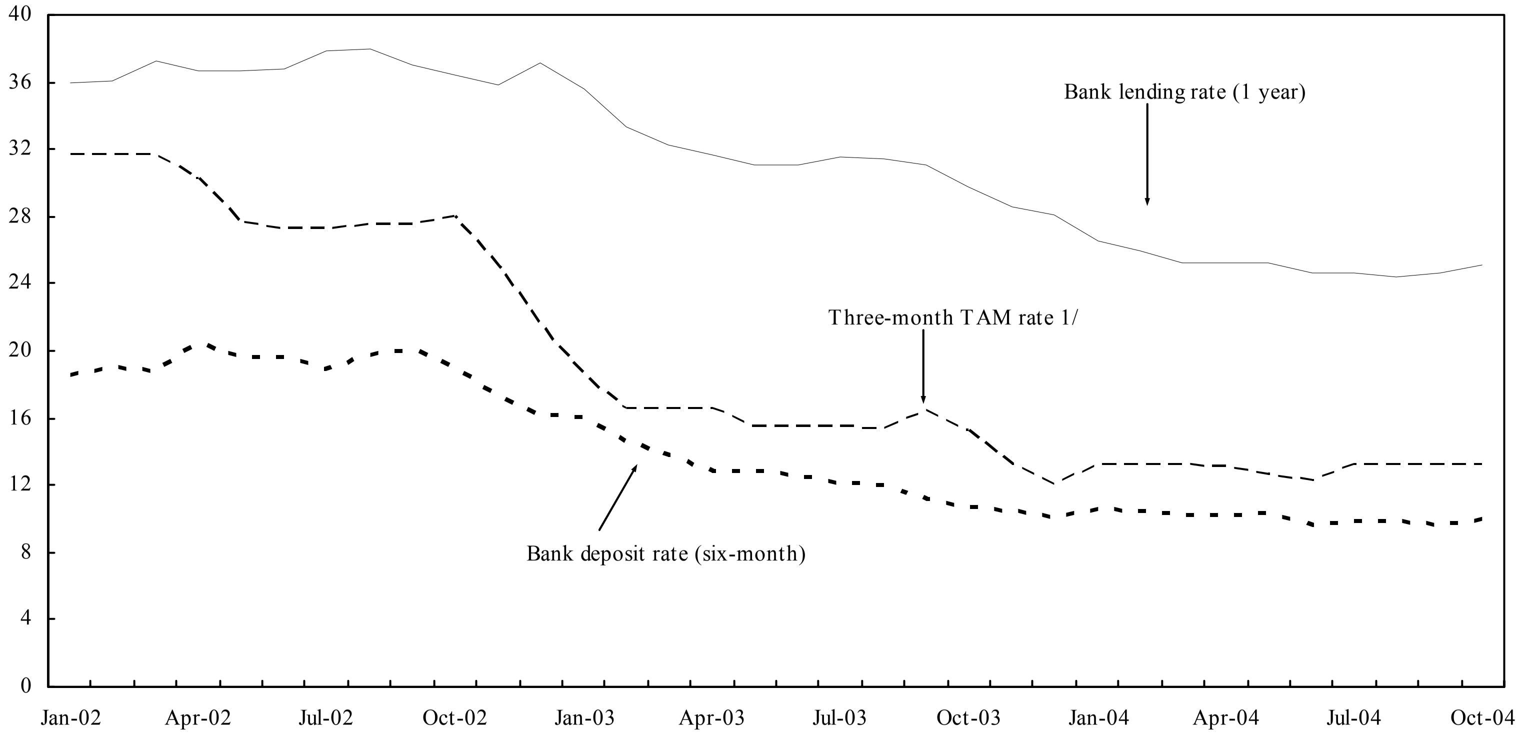


Bilateral Nominal Exchange Rates, January 1999 - December 2004
(January 1999 = 100)



Sources: Mozambican authorities and staff estimates.

Figure 3. Mozambique: Interest Rates, January 2002 - October 2004
(In percent)

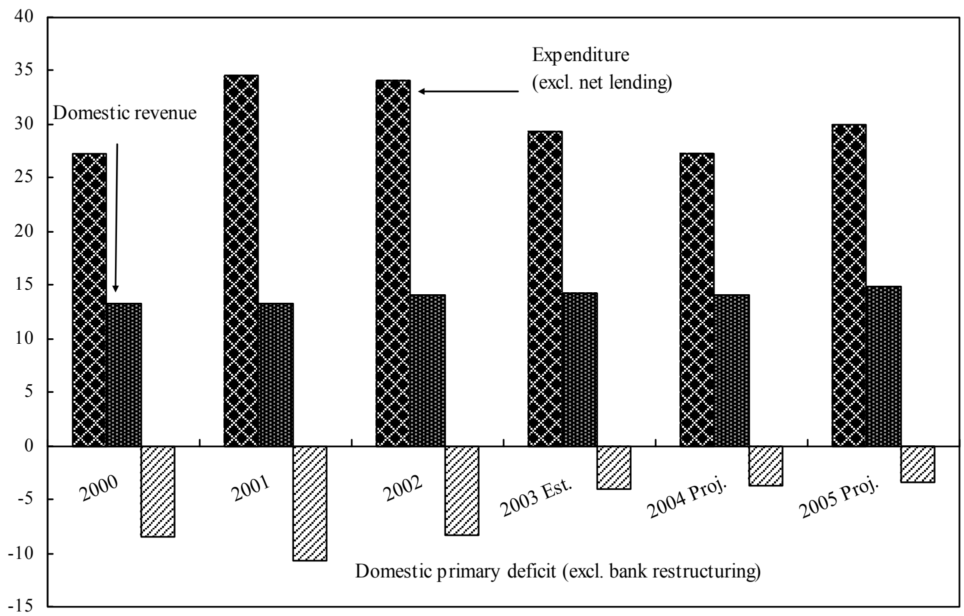


Source: Mozambican authorities; and staff estimates.

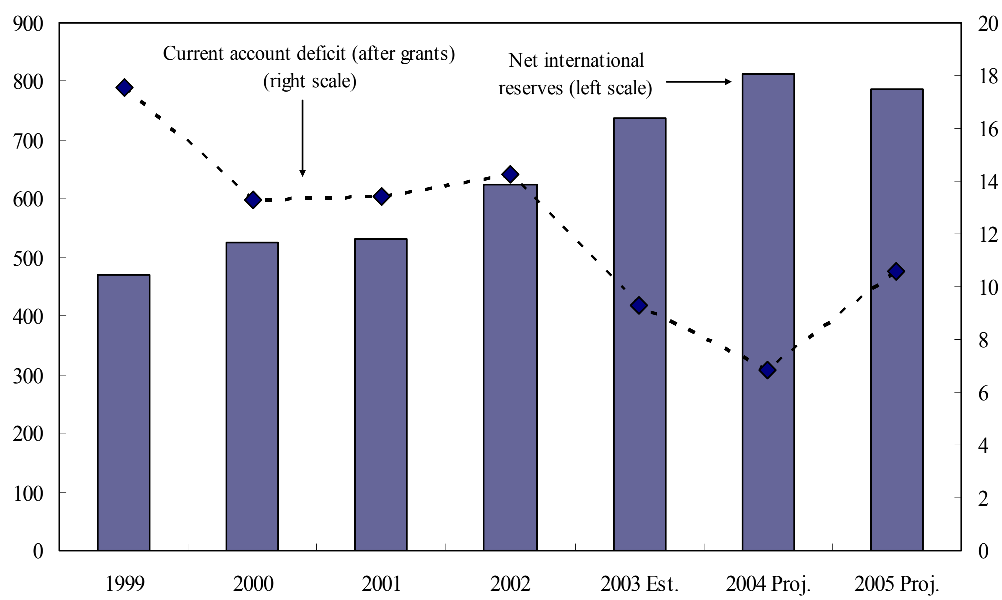
1/ Three month Monetary Authority Bill (TAM's).

Figure 4. Mozambique: Fiscal and External Sector Indicators, 2000-2005 Proj. 1/

Expenditures, Domestic Revenue, and Domestic Primary Deficit
(In percent of Gross Domestic Product)



Net International Reserves (in millions of US dollars) and
Current Account Deficit (in percent of GDP)



Sources: Mozambican authorities and staff estimates.

1/ 2004 values projected.

Table 1. Mozambique: Selected Economic and Financial Indicators, 2002-2006

	2002	2003	2004		2005	2006
	Actual	Prel.	Orig. Prog.	Rev. Proj.	Proj.	Proj.
(Annual percentage change, unless otherwise specified)						
National income and prices						
Real GDP growth	7.4	7.1	8.4	7.8	7.3	6.5
GDP per capita (in U.S. dollars)	199	233	285	291	342	355
GDP deflator	11.5	12.6	12.9	11.0	7.9	7.0
Consumer price index (end of period)	9.1	13.8	11.0	9.1	8.5	7.0
External sector						
Merchandise exports	15.2	28.9	42.8	40.7	4.1	6.9
Merchandise imports	45.1	14.5	0.0	13.0	13.3	3.7
Terms of trade	8.7	4.5	0.5	2.7	4.4	4.0
Nominal effective exchange rate (end of period) 1/	-10.0	-10.9	…	…	…	…
Real effective exchange rate (end of period) 1/	-6.4	-2.8	…	…	…	…
(Annual change in percent of beginning-period broad money, unless otherwise specified)						
Net domestic assets 2/	2.3	10.1	14.2	22.1	11.4	9.8
Of which : net credit to the government	2.9	0.3	-1.1	-1.2	8.1	4.0
credit to the economy	2.6	-0.8	9.1	5.4	6.7	6.6
Broad money (M2)	21.5	18.7	15.0	12.0	14.5	14.5
Interest rate for 90-day treasury bills/TAMs 3/	18.5	13.0	…	…	…	…
(In percent of GDP)						
Investment and saving						
Gross domestic investment	25.0	26.9	23.3	22.2	26.3	25.3
Of which Government	14.3	13.0	12.0	11.1	13.0	11.7
Gross national savings	10.7	17.6	21.5	15.4	15.7	16.1
Of which Government	10.1	9.0	8.3	6.7	7.3	7.3
Current account, after grants	-14.3	-9.3	-1.8	-6.8	-10.6	-9.2
Government budget						
Total revenue	14.2	14.3	14.6	14.0	14.9	15.3
Total expenditure and net lending (incl. residual)	34.1	29.4	27.7	27.2	29.9	28.2
Overall balance, before grants	-19.7	-15.5	-13.1	-13.2	-15.0	-13.0
Total grants	11.8	10.6	9.4	8.3	8.0	7.5
Overall balance, after grants	-7.9	-4.9	-3.8	-4.9	-7.0	-5.5
Domestic primary balance	-5.9	-4.0	-3.3	-3.6	-3.3	-3.1
External financing (incl. debt relief)	7.0	4.8	4.1	3.1	6.0	5.3
Net domestic financing 4/	0.9	0.1	-0.3	-0.3	1.0	0.1
(In percent of exports of goods and nonfactor services)						
Net present value of total public external debt outstanding 5/	91.7	105.4	84.8	91.9	92.6	89.4
External debt service (nonfinancial public sector)						
Scheduled, after original HIPC Initiative assistance	10.2	9.3	7.8	7.3	7.0	6.0
Scheduled, after enhanced HIPC Initiative assistance	7.4	7.0	5.6	5.4	5.3	4.4
Scheduled, after additional bilateral assistance	6.4	6.1	4.8	4.7	4.6	3.9
(In millions of U.S. dollars, unless otherwise specified)						
External current account, after grants	-514	-401	-95	-379	-707	-648
Overall balance of payments	98	122	0	48	-48	-11
Net international reserves (end of period)	624	738	738	813	788	808
Gross international reserves (end of period)	825	947	931	1,002	954	943
In months of imports of goods and nonfactor services	5.1	5.5	6.1	5.1	4.3	4.1
Exchange rate (meticais per U.S. dollar; end of period)	23,854	23,857	...	...	…	…
Use of Fund resources (in millions of SDRs)						
Purchases/disbursements	8.4	8.4	3.2	1.6	4.9	3.2
Repurchases/repayments, before HIPC Initiative assistance	17.1	14.8	15.3	15.3	20.5	24.6
Credit outstanding	147.1	140.7	128.6	127.0	111.4	90.0

Sources: Mozambican authorities; and staff estimates and projections.

1/ A minus sign indicates depreciation.

2/ The percentage change for Net Domestic Assets in the revised projection for 2004 has been adjusted to take account of the shifting . of the external liabilities of the BM to the government.

3/ In percent and end of period .TAMs stands for 'Titulos das Autoridades Monetarias'. TAMs are debt instruments issued by the Bank of Mozambique.

4/ Privatizations proceeds of 0.1% of GDP in 2004 and 0.1% of GDP in 2006 are not included.

5/ Public and publicly guaranteed, in percent of the three-year average of exports. Data include the impact of total debt relief under the enhanced HIPC initiative, additional bilateral, assistance, and new borrowing

Table 2. Mozambique: Government Finances, 2002-06

(In billions of meticais)

	2002	2003	2004				2005	2006
	Year Actual	Year Prel.	Q1-Q3 Prog.	Q1-Q3 Actual	Year Orig. Prog.	Year Proj.	Year Prog.	Year Proj.
Total revenue	12,057	14,714	13,352	12,321	18,350	17,595	21,654	25,198
Tax revenue	10,629	13,629	12,379	11,493	17,036	16,353	19,503	22,621
Taxes on income and profits	2,116	3,235	3,093	2,711	4,099	3,772	4,694	5,588
Taxes on goods and services	6,404	7,799	7,021	6,858	9,827	9,740	11,503	13,295
Of which : on petroleum products	865	1,305	1,137	1,214	1,605	1,715	1,983	2,270
Taxes on international trade	1,851	2,229	1,911	1,628	2,641	2,421	2,765	3,125
Other taxes	258	366	354	295	469	419	541	614
Nontax revenue	1,428	1,085	973	828	1,314	1,242	2,151	2,577
Of which previously off-budget own-generated revenues of line-ministries and districts	...	...	...	...	...	...	646	736
Total expenditure and net lending	29,032	30,189	24,594	22,862	34,888	34,132	43,362	46,626
Current expenditure	13,469	16,342	14,626	14,177	19,670	19,554	22,626	25,449
Compensation to employees	6,206	7,734	6,772	6,858	9,218	9,357	11,052	12,344
Of which financed with own-generated revenues	...	...	...	...	...	...	145	165
Of which financed with previously classified transfers to districts	...	...	...	...	...	...	206	235
Goods and services	3,163	4,039	4,010	3,399	5,074	4,698	6,061	6,857
Of which financed with own-generated revenues	...	...	...	...	...	...	499	569
Of which financed with previously classified transfers to districts	...	...	...	...	...	...	136	155
Interest on public debt	1,274	1,319	1,125	1,020	1,518	1,458	1,284	1,397
Domestic	952	1,002	853	713	1,099	955	921	946
External	322	318	272	307	418	503	362	451
Transfer payments	2,826	3,250	2,720	2,900	3,860	4,040	4,230	4,850
Domestic current primary balance	-138	-309	-149	-836	198	-501	312	1,146
Capital expenditure	12,149	13,366	9,917	7,812	15,138	13,854	18,910	19,298
Of which : locally financed	3,167	3,662	3,051	2,405	4,643	4,201	5,169	6,081
Net lending	3,414	481	51	872	80	724	1,826	1,880
Of which : locally financed	1,970	-261	51	-82	-239	-135	-16	258
Domestic primary balance, before grants, above the line, excluding bank restructuring net lending 1/	-5,275	-3,710	-3,252	-3,159	-4,207	-4,567	-4,841	-5,193
Unallocated revenue (+)/expenditure (-) 2/	209	-436	0	-109	0	0	0	0
Overall balance, before grants	-16,766	-15,910	-11,242	-10,650	-16,537	-16,537	-21,708	-21,428
Grants received	10,020	10,841	8,722	7,291	11,771	10,380	11,509	12,346
Project	6,728	6,671	4,882	3,930	7,333	6,167	7,566	8,070
Nonproject	3,292	4,170	3,839	3,361	4,438	4,212	3,943	4,277
Overall balance, after grants (before central bank recapitalization)	-6,745	-5,070	-2,520	-3,359	-4,766	-6,158	-10,199	-9,082
Central bank transfer of HIPC Initiative assistance by the IMF	538	237	224	388	360	497	368	388
Net external financing	5,401	4,741	2,258	3,562	4,774	3,453	8,377	8,431
Disbursements	5,886	5,332	2,908	4,038	5,649	6,767	8,676	8,507
Project	2,512	2,780	1,983	1,877	3,161	3,486	5,655	4,774
Nonproject	3,374	2,552	924	2,160	2,488	3,281	3,021	3,732
Cash amortization	-485	-591	-649	-476	-875	-832	-819	-449
Investment abroad 3/	...	...	...	...	...	-2,482	520	373
Net domestic financing	806	92	24	-751	-387	-398	1,455	161
Privatization 4/	...	0	14	161	18	2605	0	102
Memorandum items:								
Domestic primary balance, before grants, below the line,	-5,066	-4,146	-3,252	-3,268	-4,207	-4,567	-4,841	-5,193
excluding bank restructuring net lending 1/	-3,068	-4,146	-3,252	-3,268	-4,207	-4,567	-4,841	-5,193
Bonds issuance to strengthen the central bank's net worth	...	...	...	...	...	...	1,500	1,500
Nominal GDP	85,206	102,753	...	...	125,781	125,275	144,939	165,156

1/ 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.

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

3/ Tracks the movements in the government account set up abroad with the proceeds of the Moatize coal mine concession.

4/ Includes the US$123 million concession fee for the Moatize coal mine.

Table 2. Mozambique: Government Finances, 2002-06 (concluded)

	2002	2003	2004		2005	2006
	Actual	Prel.	Orig. Prog.	Proj.	Prog.	Proj.
	(In percent of GDP, unless otherwise specified)					
Total revenue	14.2	14.3	14.6	14.0	14.9	15.3
Tax revenue	12.5	13.3	13.5	13.1	13.5	13.7
Taxes on income and profits	2.5	3.1	3.3	3.0	3.2	3.4
Taxes on goods and services	7.5	7.6	7.8	7.8	7.9	8.0
Of which : on petroleum products	1.0	1.3	1.3	1.4	1.4	1.4
Taxes on international trade	2.2	2.2	2.1	1.9	1.9	1.9
Other taxes	0.3	0.4	0.4	0.3	0.4	0.4
Nontax revenue	1.7	1.1	1.0	1.0	1.5	1.6
Of which previously off-budget own-generated reven of line-ministries and districts	...	...	...	...	0.4	0.4
Total expenditure and net lending	34.1	29.4	27.7	27.2	29.9	28.2
Current expenditure	15.8	15.9	15.6	15.6	15.6	15.4
Compensation to employees	7.3	7.5	7.3	7.5	7.6	7.5
Of which financed with own-generated revenues	...	...	...	...	0.1	0.1
Of which financed with previously classified transfer	...	...	...	...	0.1	0.1
Goods and services	3.7	3.9	4.0	3.8	4.2	4.2
Of which financed with own-generated revenues	...	...	...	...	0.3	0.3
Of which financed with previously classified transfer	...	...	...	...	0.1	0.1
Interest on public debt	1.5	1.3	1.2	1.2	0.9	0.8
Domestic	1.1	1.0	0.9	0.8	0.6	0.6
External	0.4	0.3	0.3	0.4	0.3	0.3
Transfer payments	3.3	3.2	3.1	3.2	2.9	2.9
Domestic current primary balance	-0.2	-0.3	0.2	-0.4	0.2	0.7
Capital expenditure	14.3	13.0	12.0	11.1	13.0	11.7
Of which : locally financed	3.7	3.6	3.7	3.4	3.6	3.7
Net lending	4.0	0.5	0.1	0.6	1.3	1.1
Of which : locally financed	2.3	-0.3	-0.2	-0.1	0.0	0.2
Domestic primary balance, above the line, excluding bank restructuring net lending 1/	-6.2	-3.6	-3.3	-3.6	-3.3	-3.1
Unallocated revenue (+)/expenditure (-) 2/	0.2	-0.4	0.0	0.0	0.0	0.0
Overall balance, before grants	-19.7	-15.5	-13.1	-13.2	-15.0	-13.0
Grants received	11.8	10.6	9.4	8.3	7.9	7.5
Project	7.9	6.5	5.8	4.9	5.2	4.9
Nonproject	3.9	4.1	3.5	3.4	2.7	2.6
Overall balance, after grants (before central bank recapitaliz	-7.9	-4.9	-3.8	-4.9	-7.0	-5.5
Central bank transfer of HIPC assist. by the IMF	0.6	0.2	0.3	0.4	0.3	0.2
Net external financing	6.3	4.6	3.8	2.8	5.8	5.1
Disbursements	6.9	5.2	4.5	5.4	6.0	5.2
Project	2.9	2.7	2.5	2.8	3.9	2.9
Nonproject	4.0	2.5	2.0	2.6	2.1	2.3
Cash amortization	-0.6	-0.6	-0.7	-0.7	-0.6	-0.3
Investment abroad 3/	...	...	...	-2.0	0.4	0.2
Net domestic financing	0.9	0.1	-0.3	-0.3	1.0	0.1
Privatization 4/	...	...	0.0	2.1	0.0	0.1
Memorandum items:						
Domestic primary balance, before grants	-5.9	-4.0	-3.3	-3.6	-3.3	-3.1
excluding bank restructuring net lending 1/	-3.6	-4.0	-3.3	-3.6	-3.3	-3.1
Domestic public debt 5/	3.8	4.8	...	2.0	2.3	2.7
Bonds issuance to strengthen the central bank's net worth	...	...	...	...	1.0	0.9
Nominal GDP (in billions of meticais)	85,206	102,753	125,781	125,275	144,939	165,156

Sources: Mozambican authorities; and staff estimates and projections.

1/ 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.

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

3/ Tracks the movements in the government account set up abroad with the proceeds of the Moatize coal mine concession.

4/ Includes the US$123 million concession fee for the Moatize coal mine.

5/ Includes government securities issued to strengthen the balance sheet of the Bank of Mozambique.

Table 3: Mozambique: Monetary Survey, December 2002 - December 2005

	2002	2003		2004					2005			
	Dec.	Dec.	Dec.	Jun.	Jun.	Sep.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.
	Actual	Actual	Rev.Act.	Prog.	Actual	Prog.	Actual	Rev. Proj.	Prog.	Prog.	Prog.	Prog.
	(In billions of meticais, unless otherwise specified)											
Central bank												
Net foreign assets	3,935	7,104	7,104	6,371	6,757	18,900	18,887	17,555	19,287	19,492	18,498	18,702
(in millions of U.S. dollars)	165	298	298	263	294	775	883	857	892	898	841	830
Net international reserves 1/	14,902	18,575	17,606	17,130	17,185	17,828	17,895	16,649	18,331	18,316	17,525	17,751
(in millions of U.S. dollars)	625	779	738	708	747	731	837	813	848	844	797	788
Medium- and long-term foreign liabilities 2/	-11,457	-11,806	-11,806	-12,091	-11,280	-268	-61	-102	-108	109	-110	-158
Other	489	336	1,304	1,332	852	1,340	1,053	1,008	1,064	1,068	1,082	1,109
Net domestic assets	3,198	1,578	1,578	1,931	1,919	-10,270	-9,760	-7,190	-9,969	-9,373	-8,023	-6,982
Credit to government (net)	-4,489	-5,961	-5,961	-5,492	-5,006	-5,938	-5,700	-5,759	-6,786	-5,222	-4,612	-4,031
Credit to banks (net)	-2,222	-3,208	-3,208	-4,602	-5,095	-4,718	-6,318	-4,787	-6,789	-6,506	-5,967	-5,707
Credit to the economy	1	1	1	1	1	1	1	1	1	1	1	1
Other items (net; assets +)	9,909	10,746	10,746	12,024	12,019	386	2,258	3,355	3,605	2,355	2,555	2,755
Reserve money	7,132	8,682	8,682	8,303	8,676	8,630	9,126	10,365	9,317	10,120	10,475	11,720
Currency outside banks	3,486	4,259	4,259	4,132	4,233	4,240	4,518	5,094	4,280	4,790	5,076	5,729
Bank reserves	3,647	4,423	4,423	4,170	4,443	4,391	4,608	5,271	5,037	5,329	5,398	5,990
Currency in banks	612	752	752	600	624	700	568	864	676	718	805	994
Deposits	3,034	3,671	3,671	3,570	3,819	3,691	4,040	4,406	4,361	4,612	4,593	4,996
Deposit money banks												
Net foreign assets	8,133	7,308	7,308	5,779	6,559	6,021	5,366	6,103	5,513	6,056	5,937	6,083
(in millions of U.S. dollars)	341	306	306	239	285	247	251	298	255	279	270	270
Net domestic assets	15,548	20,690	20,690	22,884	22,354	23,657	23,043	24,930	25,582	26,874	26,589	29,554
Banks' reserves	3,647	4,423	4,423	4,170	4,443	4,391	4,608	5,271	5,037	5,329	5,398	5,990
Central bank liabilities w/coml. banks (net)	2,123	3,472	3,472	4,602	5,396	4,718	6,550	4,787	6,789	6,506	5,967	5,707
Credit to government (net)	856	2,420	2,420	2,889	1,899	2,443	1,408	1,820	1,820	1,820	2,430	3,011
Credit to the economy	14,525	14,320	14,320	15,051	14,506	15,802	14,159	16,071	15,234	16,569	16,244	18,495
Other items (net; assets +)	-5,603	-3,945	-3,945	-3,828	-3,890	-3,697	-3,682	-3,018	-3,298	-3,351	-3,449	-3,649
Deposits	23,682	27,998	27,998	28,663	28,913	29,678	28,409	31,034	31,095	32,930	32,526	35,637
Demand and savings deposits	16,199	18,901	18,901	18,705	18,934	19,332	18,347	19,893	19,595	20,930	20,126	22,747
Time deposits	7,483	9,097	9,097	9,959	9,979	10,346	10,061	11,141	11,500	12,000	12,400	12,890
Monetary survey												
Net foreign assets	12,068	14,412	14,412	12,151	13,316	24,920	24,253	23,658	24,800	25,548	24,435	24,785
Net domestic assets	15,100	17,845	17,845	20,645	19,830	8,997	8,674	12,470	10,576	12,172	13,168	16,582
Domestic credit	10,893	10,779	10,779	12,449	11,399	12,308	9,867	12,133	10,269	13,168	14,062	17,476
Credit to government (net)	-3,633	-3,541	-3,541	-2,602	-3,107	-3,495	-4,293	-3,939	-4,966	-3,402	-2,182	-1,020
Credit to the economy	14,526	14,320	14,320	15,052	14,507	15,803	14,160	16,072	15,235	16,570	16,245	18,496
Other items (net; assets +)	4,207	7,066	7,066	8,196	8,431	-3,310	-1,193	337	307	-996	-894	-894
Money and quasi money (M2)	27,167	32,257	32,257	32,796	33,146	33,918	32,927	36,128	35,375	37,720	37,603	41,366
Currency outside banks	3,486	4,259	4,259	4,132	4,233	4,240	4,518	5,094	4,280	4,790	5,076	5,729
Deposits	23,682	27,998	27,998	28,663	28,913	29,678	28,409	31,034	31,095	32,930	32,526	35,637
	(12-month percent change, unless otherwise indicated)											
Memorandum items:												
M2 growth	21.5	18.7	18.7	15.2	16.4	15.1	11.7	12.0	13.5	13.8	14.2	14.5
Cred.econ. adjusted for write offs (annual growth)	10.9	14.1	14.1	8.0	7.1	10.4	7.9	14.9	7.3	14.2	14.7	15.1
Currency/M2 (in percent)	12.8	13.2	13.2	12.6	12.8	12.5	13.7	14.1	12.1	12.7	13.5	13.9
Reserve money growth (12 months)	17.8	21.7	21.7	19.1	24.5	18.5	25.3	19.4	18.4	16.6	14.8	13.1
Money multiplier (M2/reserve money)	3.8	3.7	3.7	4.0	3.8	3.9	3.6	3.5	3.8	3.7	3.6	3.5

Sources: Bank of Mozambique; and staff estimates and projections.

1/The NIR program and actual figures for 2004 and the NIR actual for 2003 have been revised downward by deducting from gross reserves some deposits held by the central bank abroad which are encumbered for specific imports.

2/ In July 2004, part of the Medium- and long-term foreign liabilities of the Central Bank (11,023.5 billions of meticais) were transferred to the Treasury. This account was offset by "other items" in net domestic assets.

Table 4. Mozambique: Balance of Payments, 2002-2006

(In millions of U.S. dollars, unless otherwise specified)

	2002 Act.	2003 Prel.	2004 Rev. proj.	2005 Prog.	2006 Proj.
Trade balance	-733	-723	-526	-731	-709
Exports, f.o.b.	810	1,044	1,469	1,529	1,635
Large projects	468	681	1,094	1,132	1,215
Other exports	341	363	375	398	421
Imports, c.i.f.	-1,543	-1,767	-1,996	-2,260	-2,345
Large projects	-402	-337	-363	-460	-500
Other imports	-1,141	-1,429	-1,633	-1,800	-1,845
Services and incomes (net)	-181	-192	-335	-532	-495
Receipts	415	358	384	410	437
Expenditures	-596	-549	-719	-942	-932
Of which : interest on public debt	-27	-26	-27	-29	-30
Current account, before grants	-914	-915	-862	-1,262	-1,204
Unrequited official transfers	400	514	483	556	557
Of which : multilaterals' HIPC assistance grants	20	22	23	26	27
Current account, after grants	-514	-401	-379	-707	-648
Capital account	871	433	402	634	612
Trade credit (net)	-129	-94	0	0	0
Foreign borrowing	802	395	409	620	615
Public 1/	259	236	294	405	369
Private 2/	543	160	115	215	246
Amortization	-182	-210	-238	-266	-291
Public 1/	-61	-68	-66	-74	-71
Private	-121	-142	-172	-192	-220
Direct investment (net)	380	342	353	256	272
Of which Moatize coal mine	0	0	123	0	0
Other investment of the government 3/	0	0	-123	24	16
Short-term capital and errors and omissions (net)	-259	90	25	25	25
Overall balance	98	122	48	-48	-11
Financing	-98	-122	-48	48	11 0
Of which: Bank of Mozambique					
gross reserve assets (increase -)	-98	-122	-48	48	11
Financing gap	0	0	0	0	0
Memorandum items:					
Use of Fund credit (net)	-11	-9	-20	-23	-31
Current account deficit (percent of GDP)					
Before grants	25.4	21.2	15.6	19.0	17.0
After grants	14.3	9.3	6.8	10.6	9.2
After grants, excluding large projects	8.6	10.6	15.0	13.8	13.3
Net international reserves	624	738	813	788	808
Gross international reserves	825	947	1,002	954	943
In months of imports of G&NFS	5.1	5.5	5.1	4.3	4.1
In months of imports of GNFS, excl. large projects	7.0	6.9	6.1	5.3	5.1
Gross foreign assets of the government			123	99	83
Debt Indicators (in percent) 4/					
NPV of public external debt/GDP	24.8	28.8	24.6	23.0	24.1
NPV of public external debt/exports	91.7	105.4	91.9	92.6	89.4
NPV of public external debt/revenue	175.4	201.3	175.0	154.0	157.7
Debt service due/exports	6.4	6.1	4.7	4.6	3.9
Debt service due/revenue	12.2	11.6	8.9	7.7	6.9

Sources: Mozambican authorities; and staff estimates and projections.

1/ Including IMF.

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

3/ Tracks the movements in the government account set up abroad with the proceeds of the coal mine concession.

4/ Figures in NPV terms for 2002 are not directly comparable to those for the following years due to a change in methodology.

Table 5. Mozambique: External Financing Requirements and Sources, 2002-2006
(In millions of U.S. dollars)

	2002 Act.	2003 Prel.	2004 Rev. Proj.	2005 Proj.	2006 Proj.
External financing requirements	1,581	1,251	1,123	1,456	1,459
Current account, excluding grants	914	915	862	1,262	1,204
Amortization 1/	182	210	238	266	291
Trade credit (net, increase +)	129	94	0	0	0
Changes in arrears (increase -)	0	0	0	0	0
Changes in reserve assets (increase +) 2/	98	122	48	-48	-11
Short-term capital and errors and omissions (net; outflow +) 3/	259	-90	-25	-25	-25
Total identified financing	1,581	1,251	1,123	1,456	1,459
Disbursements from existing and new commitments	1,201	909	892	1,175	1,171
Grants 4/	400	514	483	556	557
Loans	802	395	409	620	615
Bilateral	0	13	8	16	16
Multilateral 1/	259	223	287	389	352
IDA	148	155	186	228	208
IMF	11	12	2	7	5
Other	100	56	98	154	140
Private sector	543	160	115	215	246
Foreign direct investment	380	342	353	256	272
Other investment of the government	0	0	-123	24	16
Debt relief 5/	0	0	0	0	0
Remaining gap	0	0	0	0	0
Memorandum items:					
Total reduction in debt service due (debt relief) 5/	416	404	351	292	166
Assistance on traditional mechanisms	286	270	216	156	35
Assistance under the original HIPC Initiative	93	95	96	96	91
Assistance under the enhanced HIPC Initiative	27	27	28	30	31
Assistance under additional bilateral relief	10	11	10	10	10
Paris Club deferral (flood relief)	0	0	0	0	0
Offcial grants and loans, excl. multilateral HIPC assistance 2/	632	727	754	934	898

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 debt relief assistance by IDA, AfDB and IMF under the original and enhanced HIPC Initiatives.
5/ Debt relief is shown as an above-the-line item as Mozambique passed its completion point in 2001.
The memorandum items provide the data on debt relief after 2001.

Maputo, January 24, 2005

Mr. Rodrigo de Rato y Figaredo
Managing Director
International Monetary Fund
Washington, D.C., 20431
U.S.A.

Dear Mr. de Rato:

1. On July 6, 2004, The Executive Board of the IMF approved a three-year arrangement for Mozambique under the Poverty Reduction and Growth Facility (PRGF). In the attached Memorandum of Economic and Financial Policies (MEFP), which supplements the MEFP dated June 4, 2004, the Government of Mozambique describes progress in implementing its program and lays out its policy intentions for 2005. A Technical Memorandum of Understanding on Selected Concepts, Definitions, and Data Reporting Requirements under the program is also attached.

2. As indicated in the MEFP, all the end-June 2004 quantitative performance criteria, as well as the structural performance criteria linked to the second disbursement under the arrangement, were observed. However, the fiscal performance through end-September 2004 was adversely affected by a significant revenue shortfall attributable to a number of factors specified in the memorandum, which has been almost entirely offset by lower spending on goods and services and locally financed capital outlays. As a result, the end-September 2004 indicative target on the domestic primary deficit was missed by a very small margin. On the monetary side, large inflows of private capital have contributed to a larger-than-programmed reserve accumulation, and the end-December 2004 performance criterion on net international reserves is likely to be exceeded. Progress has been made on the structural front, including through the partial implementation of the new financial administration system (SISTAFE) in the Ministry of Planning and Finance, which constitutes an important step toward improving public expenditure management and fiscal transparency.

3. The Government remains committed to strengthening the revenue performance and believes that the policies and measures set out in the attached memorandum are adequate to achieve the objectives of its program, but it is willing to take any further measures that may become appropriate for this purpose. On this basis, the government requests (i) the completion of the first review; and (ii) the disbursement of the second loan under the arrangement.

4. The Government will continue to consult with the Fund on its economic and financial policies, in accordance with the Fund's policies on such consultations, and to provide the Fund with such information as the Fund needs to assess the government's progress in implementing the economic and financial policies described in the MEFP. The second review under the PRGF arrangement will be completed not later than end-June 2005, based on the

quantitative performance criteria for end-December 2004, and the structural performance criteria and benchmarks through end-April 2005. The third review will take place by end-November 2005 and will make available the fourth disbursement, which will be subject to the end-June 2005 quantitative performance criteria and structural performance criteria and benchmarks, and other structural performance criteria to be determined at the time of the second review. The phasing and conditions for further disbursements under the arrangement will be determined at the time of the third review.

Sincerely yours,

/s/ Luisa Dias Diogo Prime Minister and Minister of Planning and Finance	/s/ Adriano Afonso Maleiane Governor Bank of Mozambique

Attachments

Memorandum of Economic and Financial Policies of the Government of Mozambique for the First Review Under the PRGF Arrangement

I. Recent Developments and Program Implementation

1. On July 6, 2004, the Executive Board of the International Monetary Fund approved a new arrangement under the Poverty Reduction and Growth Facility (PRGF) to support the government of Mozambique's economic program for the period 2004-06. The government presents this memorandum in support of its request for the second loan disbursement under the PRGF arrangement. The economic and financial policies and related structural reforms described in the memorandum aim to consolidate macroeconomic stability and sustain strong broad-based growth in order to promote employment and further reduce poverty. These policies are consistent with achieving the goals set out in the Plano de Acção Para a Redução da Pobreza Absoluta (PARPA) approved by the government in 2001.

2. Macroeconomic developments in 2004 continued to be broadly favorable. Based on preliminary information, real GDP is estimated to have increased by close to 8 percent for the year as a whole, owing to MOZAL II and the gas pipeline coming into full operation, a significant expansion in the manufacturing and telecommunications sectors, and continued strong performance of services. Inflation declined from 13.8 percent during 2003 to 9.1 percent in 2004, which is below the program's end-year target of 11 percent. All the program's quantitative performance criteria for end-June 2004, as well as the structural performance criteria linked to the second disbursement under the arrangement, were observed (Tables 1 and 2).

3. The government's domestic primary deficit for the first nine months of 2004 (measured from the financing side) turned out marginally higher than programmed. Total revenue was significant below the end-September indicative target owing to higher-than-programmed reimbursements of the value-added tax (VAT), a weaker-than-envisaged performance of customs duties collection attributable in part to the recent appreciation of the metical, and delays incurred by corporations in complying with the payments calendar under the new corporate income tax code. The revenue shortfall was compensated by lower spending on goods and services and locally financed capital outlays. The end-September indicative target on the wage bill was exceeded because of the decision to retain some contractual personnel employed last year in the education sector to help meet the government's objectives in this priority area. The government has continued to adjust domestic petroleum prices on a monthly basis in line with developments in import prices, and has increased specific fuel taxes on a quarterly basis broadly in line with inflation during the previous three months.

4. The end-June 2004 quantitative performance criteria and end-September 2004 indicative targets on the net domestic assets of the Bank of Mozambique (BM) and net international reserves were observed. The indicative targets for base money were exceeded, however, owing to an underestimation of the impact of recent modifications in reserve

requirements. Broad money growth declined to about 12 percent in September 2004, significantly below the program's target.

5. In recent months, the BM has taken several steps to strengthen monetary management. In particular, it has increased the use of foreign exchange sales to sterilize liquidity, which has led to a nominal appreciation of the metical against the U.S. dollar of 20.8 percent during 2004. In late June 2004, the application of legal reserve requirements was broadened to nonresident deposits and escrow deposits, and in September 2004, a single instrument (treasury bills) was introduced for both monetary policy purposes and financing of the government, with the central bank bearing the cost of the bills issued for sterilization purposes. Moreover, the foreign exchange function of the Foreign Department of the BM was transferred to the Markets Department, which will contribute to a better coordination of domestic market and foreign exchange market operations. In addition, the spread in the interest rate corridor on the central bank standing facilities was narrowed to improve the signaling powers of monetary policy, and the lending and absorption interest rates were lowered by 5 and 2 percentage points during 2004, to 13.5 percent and 6¼ percent, respectively. The government's prudent macroeconomic management facilitated a decline in commercial banks' lending rates from 37 percent at end-2002 to 24¼ percent in November 2004, but interest spreads are still high at 13–14 percent.

6. The balance of payments continued to reflect developments in the megaprojects during the first half of 2004. The trade statistics have been revised significantly to reflect a widening of the coverage of the customs trade and information management system and to correct data processing problems that in the past led to an underestimation of imports. Exports in the first half of the year were almost 65 percent higher than in the same period of 2003. This performance reflected the completion of MOZAL II in late 2003, which led to a doubling of MOZAL's production and export capacity, and the beginning of operations of the gas pipeline. Imports increased strongly (about 18 percent), boosted by MOZAL II and higher oil import prices. On the whole, the external current deficit after grants is estimated to have declined to about 7 percent of GDP in 2004, from 9¼ percent in 2003, being more than covered by higher than programmed disbursements of external aid and large inflows of private capital. Net international reserves are expected to increase by US$75 million in 2004, compared with zero change envisaged in the program.

7. Progress was made on the structural front in 2004, and the three structural performance criteria linked to the second disbursement under the arrangement were observed. In June 2004, the government submitted to the assembly a draft general tax law, and in July, the balance sheet of the BM was strengthened by shifting a large part of its external liabilities to the government. In addition, the supervisory regime for BIM has been kept in place, with the monthly data on BIM's financial statements showing that the bank remains profitable and continues to comply with prudential requirements.

8. Performance regarding the program's structural benchmarks has been mixed (see Table 2). Specifically, (i) the submission of the draft law creating the Central Revenue Authority (ATM) to the assembly was completed in early August 2004, rather than in July;

(ii) preparation of the quarterly budget execution report based on the new financial administration system (e-SISTAFE) is now expected to start in the first quarter of 2005, rather than the third quarter of 2004; and (iii) the BM has adopted measures to strengthen the financial position of one small bank but is still studying the resolution strategy for another small institution. The regulations of the new Financial Institutions Law approved in July 2004 and a revised regulatory framework for microfinance activities have already been completed. The government has also begun to implement steps to strengthen the central bank balance sheet in accordance with the legal provisions in the BM Act (see paragraph 22).

9. With technical support from the World Bank, the government is also working on a feasibility study on the divestment of its participation in BIM (structural performance criterion for end-December 2004). The study is now expected to be completed by end-June 2005, rather than by end-2004, as originally envisaged, as the government wishes to refine its strategy with technical support from the World Bank. Regulations for the anti-money laundering law were issued in August 2004, but the establishment of a financial investigations unit will take longer than anticipated because it is likely to require additional legislation.

10. Notwithstanding the delays referred to above, the implementation of the SISTAFE has continued to move forward. A key step was taken in June 2004 by issuing a revision of Decree 17, which stipulates financial procedures for the government that are fully consistent with the SISTAFE. Moreover, as of November 1, 2004, the e-SISTAFE was made operational in the Ministry of Planning and Finance (MPF) and began to process all transfers of funds between a consolidated treasury account and the accounts of the central and provincial administrative directorates of the MFP. Based on the current schedule, the implementation of budget execution and reporting through the e-SISTAFE in the MPF, including the provincial directorates, is expected to start as soon as the 2005 budget is approved by the new assembly (the old manual will function for a while as a back-up).

11. In November 2004, the government signed a contract with the Brazilian company Companhia Vale do Rio Doce (CVRD) for coal prospecting and exploration in the province of Tete. CVRD already paid a signing fee in the amount of US$123 million (2.2 percent of GDP), which has been deposited in a government account abroad (with the central bank acting as agent), with the view of establishing a savings fund. Out of this amount, the government intends to use US$24 million in 2005, US$16 million in 2006, and US$9 million in 2007 to finance a water project and the construction of six bridges.

II. The Macroeconomic Framework for 2005-06

12. Following the coming on line of Mozal II and the gas pipeline in 2004, real GDP growth is projected to slow somewhat to 7 to 7.5 percent a year in 2005-06. Inflation (end-of-period) is targeted to decline further to 8.5 percent in 2005 and 7 percent in 2006 as a result of the maintenance of prudent fiscal and monetary policies. Aid flows (grants and concessional loans) are projected to increase from US$755 million in 2004 (13.6 percent of GDP) to US$935 million in 2005 (14.0 percent of GDP).

13. After the positive impact of the megaprojects on the trade balance in 2004, the external current account deficit after grants is projected to widen to about 10.5 percent of GDP in 2005, reflecting strong import growth associated with the initiation of a titanium ore project and an increase in dividend payments to the megaprojects' foreign shareholders. The larger current account deficit would be covered by an increase in private capital inflows in the form of foreign direct investment and private borrowing, in part related to the titanium project. Net international reserves are programmed to decline by US$25 million in 2005 and to increase slightly in 2006, with the coverage of gross reserves projected at above four months of imports by end-2006.

III. The Economic Program for 2005

A. Fiscal Policy

14. The government's domestic primary deficit is projected at 3.6 percent of GDP in 2004, compared with 3.3 percent envisaged in the program. Total revenue is now projected at 14.0 percent of GDP in 2004 (14.6 percent in the program), with the revenue shortfall being offset in part by lower spending on goods and services and locally financed capital outlays. The revised revenue target looks achievable as the delays incurred by taxpayers in complying with the new income tax system are expected to be normalized during the last quarter. Moreover, actions have been taken to strengthen customs controls in light of the shortfall in customs duties collections. Taking into account developments through September 2004, the end-December indicative target on the wage bill is expected to be exceeded by a relatively small margin.

15. The government's domestic primary deficit is programmed to decline to 3.3 percent of GDP in 2005, while the overall deficit after grants would widen to 7.0 percent of GDP (4.9 percent in 2004), owing to a substantial increase in capital outlays financed with concessional project loans and part of the resources from the CVRD payment for coal exploration. The deficit is expected to be covered, to a large extent, by net external concessional borrowing.

16. Total revenue is projected to rise to 14.9 percent of GDP in 2005. This increase reflects (i) the incorporation into the budget of the own generated revenues of districts and some line ministries (equivalent to 0.4 percentage point of GDP); (ii) the introduction of new computerized systems to support tax collection early in 2005; (iii) the expiration of tax benefits for some large projects and a better expected performance of the corporate income tax as companies become more familiar with the new system; and (iv) higher receipts of royalties from the megaprojects.

17. Noninterest current expenditure would increase from 14.4 percent of GDP in 2004 to 14.8 percent in 2005, reflecting the incorporation into the budget of the expenditures associated with the new revenue from districts and line ministries referred to above. Excluding wage outlays associated with the previously off-budget revenue, the government's

wage bill is programmed to decline to 7.4 percent of GDP in 2005, from 7.5 percent in 2004. This projection includes the impact of an increase of close to 10,000 in the number of government employees, most of which is concentrated in the priority sectors. To accommodate such increase within the envisaged target, the average general wage increase for government employees to become effective on April 1, 2005, will be limited to 6.5 percent. Locally financed capital expenditure is programmed to increase relative to its 2004 level. The expenditure projections for 2005 include the impact on the interest bill of servicing the transfer of the BM's external debt liabilities to the government and of the additional domestic debt associated with the issuance of government securities to strengthen the BM's balance sheet. Spending on PARPA priorities is expected to increase from 65.0 percent of total primary expenditure in 2004 to 67.3 percent in 2005.

18. The program for 2005 includes measures to strengthen the tax system and public sector management. On the revenue side, preparations will continue for establishing the Central Revenue Authority (ATM) by end-2005. In particular, by end-April 2005 the government will approve the internal regulations and the statute for the staff of the internal revenue administration (DGI) to strengthen its operations and facilitate its subsequent integration with the customs office (DGA). Moreover, following the expected approval by the assembly of the new general tax law and the law of creation of the ATM, during the second half of 2005 the government will issue the corresponding regulations for these two pieces of legislation. In addition, a revised tax code for the municipalities has been submitted to the Council of Ministers, and modern procedures and regulations for tax audits will be developed and implemented by end-June 2005. The government will also continue to make every effort to avoid delays in reimbursing the VAT, and it has reduced the legal requirement to make reimbursements from 60 days to 30 days.

19. The e-SISTAFE information system will be rolled out to the line ministries, starting with the Ministry of Education by end-June 2005. At the same time, the current budget management practices will be improved to increase transparency and efficiency. In particular, advancements of funds (adiantamento de fundos) will be abolished concurrently with the rollout of the SISTAFE in each ministry, which will imply that all budget transactions will have to be effected through a consolidated treasury account. Moreover, further steps will be taken to expand as much as possible the coverage of the budget, including by incorporating extrabudgetary expenditures financed with donor support.

B. Monetary and Exchange Rate Policies and the Financial Sector

20. The monetary program for 2005 will seek to achieve a further reduction in end-year inflation to 8.5 percent. In line with anticipated money demand, broad money growth is projected at 14.5 percent in 2005, compared with 12 percent now estimated for 2004. Assuming a decline of US$25 million in net international reserves, the monetary program provides room for an increase in credit to the private sector broadly in line with nominal GDP. The central bank will continue to monitor price developments closely and will be ready to sterilize liquidity as needed to achieve the program's inflation objective.

21. As noted above, the central bank has taken some steps to improve liquidity sterilization by using sales of foreign exchange, with the view of reducing the reliance placed in recent years on sterilization operations with domestic instruments, which has contributed to the bank's operating losses. In line with recommendations made in the context of the FSAP, further measures will be adopted in the next few months in the same direction, and the BM will seek to limit intervention in the foreign exchange market to achieving the international reserve targets. In this regard, the BM has prepared a step-by-step plan to strengthen exchange rate management with technical support from a Fund expert. Based on this plan, the BM intends to put in place a foreign exchange auction system by end-February 2005. Steps will also be taken to improve coordination between the BM and the Treasury in order to ensure compliance with the program's monetary targets.

22. The government remains committed to strengthening the balance sheet of the BM. To this end, in line with articles 14 and 66 of the BM's Act, starting in 2005 the government will issue securities at market interest rates. The first issuance of securities in an amount of Mt 1.5 trillion, together with the corresponding interest payments, was included in the draft budget for 2005. These securities will be issued and transferred to the BM no later than end-June 2005, and further issuances in similar amounts will take place in 2006 and 2007. These measures will be accompanied by additional steps to shift the cost of managing monetary policy over time to the budget, and by actions to reduce the administrative expenses of the central bank.

23. The authorities are also committed to implementing International Financial Reporting Standards (IFRS) in the banking institutions, a process that will be carried out with technical assistance from the World Bank. In this regard, following the completion of the diagnostic review of BIM, the reviews of three other large banks financed by DFID have already started and are expected to be completed in December 2004. Because of administrative delays in initiating these reviews, the development of a timetable to adopt IFRS and strengthen loan classification and provisioning in line with best international practices, which was originally scheduled for end-2004, is now expected to be ready by end-February 2005. At the same time, the current supervisory regime for BIM will be kept in place until approval of the bank's financial statements for 2004 by its external auditors.

24. In the area of banking supervision, progress is being made in drafting an inspection manual, preparing models for the presentation of consolidated financial statements as part of the Regulation on Consolidated Supervision, and increasing the staff and capabilities of the Department of Banking Supervision with the support of a Fund expert. Moreover, a draft of a new regulation on the assessment, classification, and provisioning of credits is under preparation.

C. External Sector Issues

25. No significant changes in the area of trade policy are expected to take place during 2005. Regarding the exchange system, the central bank is preparing a draft of a new foreign exchange law to clarify and improve the existing legislation, which will be submitted to the

assembly in the second half of 2005. Following approval of the new law and issuance of certain regulations, the government intends to accept the obligations under Article VIII of the Fund's Articles of Agreement. The government remains committed to lowering the maximum import tariff rate applicable to all trading partners from 25 to 20 percent in 2006.

26. 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 creditors in November 2001. The government has already concluded bilateral agreements with 10 out of 12 Paris Club creditors, including an agreement with Brazil signed in August 2004. Progress with non-Paris Club creditors, however, has been limited. The government remains committed to continuing with efforts to complete the negotiations with remaining Paris Club creditors, and to reach agreements with non-Paris Club official creditors and commercial creditors on comparable terms. Regarding the sovereign commercial debt, the World Bank has made a commitment to finance a debt-reduction operation through the IDA Debt Reduction Facility, and the government is working with hired consultants on the details of a proposal. A Consultative Group Meeting to seek donor support for the government's economic and structural reform program is expected to be convened by the new administration during the first half of 2005.

27. 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; and will not impose or intensify import restrictions for balance of payments reasons. Furthermore, the government will not incur any external payments arrears (continuous performance criterion). In this connection, delays in payments related to cases where debt-restructuring agreements are still pending notwithstanding good faith efforts by the government will not be considered arrears.

D. Other Structural Reforms, Governance, and Poverty Issues

28. The government recognizes the importance of removing a number of obstacles to private sector development. In this regard, steps are being taken to (i) reduce the cost of doing business in Mozambique; (ii) address rigidities in the labor market; and (iii) improve basic infrastructure. In addition, the government remains committed to improving the functioning of the judicial system, reforming the public sector, and modifying current regulations and practices to allow for the development of a tradable leasehold system facilitating the use of land as bank collateral.

29. The government has continued to work on reducing red tape for the registration of new companies in Mozambique. New regulations to simplify inspection procedures were issued earlier this year, one-stop shops for business registration were established in three locations in recent months, and a new decree streamlining the licensing of commercial activities was issued in mid-September 2004. In addition, the government is considering steps to reduce the time required for customs clearance in order to permit a more fluid transit of goods to and from South Africa. In this regard, preparations have started for establishing a facility to handle road cargo in the Mahotas railroads terminal, but the process has taken

more time than envisaged originally. The government believes that, over the medium term, addressing this problem would require the construction of a dry port in Ressano Garcia. To that end, terms of reference for the bidding process are being prepared and consultations have been initiated with the private sector and the South African authorities.

30. Regarding labor regulations, progress has been made in streamlining the procedures for hiring expatriates following the approval of a decree earlier this year. In addition, the government approved recently the terms of reference for the preparation of a revised labor law aimed at increasing flexibility in the labor market by reducing retrenchment costs, facilitating temporary employment, and addressing some remaining issues concerning the employment of expatriates. After consultation with the interested parties, the draft of the law is expected to be submitted to the assembly during the second half of 2005.

31. The government has continued to make efforts to enhance Mozambique's infrastructure in the context of several project loans from the World Bank. The tenders for sale of the telecommunications company and the national airline are expected to be issued by July 2005; management contracts for water systems have been completed in five major cities; and private concessions have been granted to operate some ports, including Maputo. In addition, the government is considering strategic options for divesting PETROMOC, the state-owned petroleum distributor.

32. In the area of public sector reform, with support from the World Bank, work has continued in the context of a long-term program aimed at restructuring the civil service and decentralizing service delivery. In particular, the functional analysis of six major ministries has been completed, which will serve as the basis for the restructuring of these ministries over a three-year period. Moreover, a study to determine the appropriate size of the public sector and a proposal to reform the wage system in order to link remunerations more closely with performance are being prepared. In addition, a draft decree establishing procurement regulations in line with international standards is expected to be approved during the first half of 2005. Early this year, the government launched a National Survey on Governance and Corruption to obtain the opinion of citizens regarding the functioning of the public sector. The fieldwork and data analysis related to the survey are largely finished, and the government intends to publish and disseminate the results to the public in the near future.

33. The government is conscious of the need to revise land tenure regulations to facilitate the use of land as bank collateral. However, the Council of Ministers has been of the view that, in light of the sensitive nature of the issues involved, any reforms in this area should be preceded by a process of broad consultation with interested parties. In this regard, a draft decree to strengthen property rights in urban areas, including through titling, which was originally expected to be approved by end-July 2004, would need to be reconsidered by the new administration. The government remains committed to conducting a Poverty and Social Impact Analysis (PSIA) study on land tenure regulations and their implications for accessing bank financing during 2005. Several donors have already expressed interest in providing support for this purpose, and donors and the government are developing the project in the context of the Policy Assessment Framework (PAF) for 2005.

34. Progress in reforming the judicial system has been limited during 2004, partly as a result of capacity constraints and delays in approving relevant legislation. Efforts have continued to increase the number of judges and judicial officers and to improve their skills through training. Moreover, an anti-corruption law was recently approved by the assembly, and work is being done to prepare the regulations of the law. However, other important pieces of legislation, including the new commercial code, the Penal Code, the Penal Procedure Code, the Civil Procedure Code, and the Notary Code are still being considered by the assembly or the Council of Ministers. The tender for the implementation of a new company registry at the national level has already been launched.

IV. Safeguards Assessment and Statistical Issues

35. The BM is taking actions to address several weaknesses identified in the context of a Fund's safeguards assessment mission conducted in June 2004. In particular, (i) the Economic Research and Statistics Department of the BM has already established updated procedures for converting balance sheet data to the monetary data reported to the Fund; and (ii) starting end-November 2004, the BM began to complete all reconciliations and necessary adjustments on a monthly basis so that the balances in its accounting records match those confirmed by the correspondents, external managers, and other third parties. Moreover, work is in progress for linking the monetary data to the balance sheet electronically through the SAP system. Other measures recommended in the safeguards assessment will also be implemented in accordance with a timetable agreed with Fund staff. Steps are also being taken by the BM to adopt IFRS as its underlying financial framework. To that effect, a resolution was approved by its Board of Directors in September 2004 and a firm timetable for implementation of IFRS will be adopted by end-February 2005, with technical support from a Fund expert.

36. Although progress has been made in recent years in strengthening the statistical information, the statistical system still presents several deficiencies that hinder policy implementation and the surveillance of economic developments. In particular, significant improvements are necessary in the national accounts, the monetary data, the balance of payments, and the public finance statistics. Looking ahead, efforts will continue in these areas with technical support from the Fund and bilateral donors. In particular, by end-June 2005 INE will compile and disseminate preliminary data on the 2004 GDP and will publish a revision policy for compiling and disseminating final national accounts data. In addition, the government will continue to publish and provide to Fund staff budget execution reports corresponding to the preceding quarter with a lag not exceeding 45 days, as well as data corresponding to monthly government revenues (in detail according to the fiscal table) with a lag not exceeding one month.

37. Following the completion of the National Household Survey in 2003, several studies are being conducted by public and private institutions, including on the determinants of poverty, education attendance, demographic trends and health services, and the relationship between employment and poverty. Moreover, INE is expected to finalize a labor force survey by September 2005 that will provide information on unemployment using a variety of

definitions. A new PARPA covering the period 2006-10 will be prepared during 2005 and is expected to be ready by February 2006.

V. Program Monitoring

38. The semiannual quantitative performance criteria for end-June 2005 and the indicative targets that will be used to evaluate the implementation of the program during 2005 are shown in Table 1 of this memorandum, with further definitions and explanations contained in the annexed Technical Memorandum of Understanding. In addition, the government has specified in Table 3 a list of structural performance criteria and benchmarks for the first half of 2005. As in the past, the program's floor on net international reserves (NIR) and the ceiling on the net domestic assets (NDA) of the BM will be adjusted upward/downward for any shortfall/excess in disbursements of external program grants and loans, and downward/upward to the extent that actual payments of external debt service exceed/fall short of programmed amounts. Symmetrical adjustments will apply to net international reserves.

39. The government understands that its ability to request the disbursement of the third loan under the PRGF arrangement will be contingent upon the observance of the semiannual quantitative performance criteria for end-December 2004 set out in Table 1; the structural performance criteria set out in Table 3 through end-April 2005; and the completion of the second review under the program, which is expected to take place, at the latest, by end-June 2005. In reviewing developments under the program during the second review, particular attention will be paid to the revenue performance and the progress made in implementing the SISTAFE.

Table1. Mozambique: Quantitative Performance Criteria and Indicative Targets for 2004 and 2005

(In billions of meticais, unless otherwise specified)

	2003		2004							2005			
	End-Dec.		End-June Performance Criteria			End-Sep. Indicative Targets			End-Dec. Perf. Criteria	End-Mar. Indicat. Target	End-June Perf. Criteria	End-Sep. Indicat. Target	End-Dec. Indicat. Target
	Act.	Rev.Act.	Prog.	Adj.	Act.	Prog.	Adj.	Act.	Prog.	Prog.	Prog.	Prog.	Prog.
Government domestic primary deficit (excluding bank recapitalization costs (ceiling) 1/ 2/ 3/ 4/	4,108	4,108	2,117	...	1,692	3,259	...	3,268	4,207	857	1,764	2,640	4,841
Stock of net dom. assets of Bank of Mozambique (BM) (ceiling) 1/ 5/ 6/ 7/	1,421	1,421	1,931	2,323	1,573	1,650	-10,923	-12,398	3,299	-9,967	-9,373	-8,023	-6,982
Stock of net international reserves of the BM (floor, in millions of U.S. dollars) 1/ 8/12/	779	738	708	692	747	731	758	837	738	848	844	797	788
New nonconcessional external debt contracted or guaranteed by the central government or the BM with maturity of more than one year (ceiling) 9/	0	0	0	...	0	0	...	0	0	0	0	0	0
Stock of short-term external public debt outstanding (ceiling) 9/ 10/	0	0	0	...	0	0	...	0	0	0	0	0	0
External payments arrears (ceiling) 3/ 9/ 11/	0	0	0	...	0	0	...	0	0	0	0	0	0
Balance of the government's savings account set up abroad with proceeds from the coal exploration contract (floor, in millions of U.S. dollars, indicative target)	...	...	...	...	...	...	...	...	...	...	99	...	99
Government revenue (floor, indicative target) 3/	14,714	14,714	8,255	...	7,881	13,345	...	12,321	18,350	4,457	9,708	15,654	21,654
Stock of reserve money (ceiling, indicative target) 7/	8,682	8,682	8,303	...	8,676	8,630	...	9,126	10,247	9,317	10,110	10,475	11,720
Wage bill (ceiling, indicative target) 3/	....	....	4,485	...	4,479	6,772	...	6,858	9,218	2,123	4,708	7,598	11,052
Memorandum items:													
Foreign program assistance; grants and loans (in millions of U.S. dollars) 3/	241	241	82		68	180	...	206	264	103	163	174	243
Actual external debt service payments (in millions of U.S. dollars) 3/	50	50	25		27	38	...	38	62	13	35	56	77
Net flows	192	192	57		41	141	...	168	202	90	128	118	166
Exchange rate (meticais per U.S. dollar; end of period)	23,857	23,857	24,181		23,002	24,375	...	21,389	...	...	...	...	...
Shortfall in required reserves	...	...	...	0	...	...	...	...	...	...	...	...	...
Adjustment to BM's net domestic assets at program exch. rates	157	157			346			2,637					
Adjustment to BM's NDA target	...	...	...	392	...	...	-12,573	...	...	...	...	...	...
Adjustment to reserve money	...	...	...	0	...	...	0	...	...	...	...	...	...
Adjustment to BM's NDA due to shortfall/excess of net program assistance	...	...	...	392	...	...	-653	...	...	...	...	...	...
Stock adjustments in medium- and long-term foreign liabilities	...	...	...		...	...	-11920	...	...	...	...	...	...

1/ In 2004, constitute quantitative performance criteria for end-June and end-December, and in 2005 for end-June.

2/ Defined as revenue minus noninterest current expenditure minus locally financed capital expenditure and locally financed net lending; to be measured from below the line based on financing items.

3/ Cumulative from the beginning of the calendar year.

4/ To be adjusted upward for up to Mt400 billion to accommodate higher-than-budgeted locally financed drought-related expenditures. Also to be adjusted for end-December 2004 for up to Mt600 billion to accommodate additional capital outlays covered by higher-than-envisaged external budgetary grants.

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

6/ To be adjusted upward/downward to the extent of any shortfall/excess in 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. In 2004, the downward adjustment for higher-than-programmed budgetary grants will not take place to the extent that the additional grants are to accommodate additional capital outlays, up to 25 million U.S. dollars. To be adjusted upward for up to Mt400 billion to accommodate higher-than-budgeted locally financed drought-related expenditures.

7/ 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.

8/ 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 to the extent that actual payments of external debt service fall short of/exceed programmed amounts. In 2004, the upward adjustment for higher-than-programmed external budgetary grants will not take place to the extent that the additional grants are used to accommodate additional capital outlays, up to 25 million dollars. To be adjusted donward for up to 16 million U.S. dollars to accommodate higher-than-budgeted locally financed drought-related expenditures. Moreover, to be adjusted downward/upward for any revision made to the end-2003 and end-2004 figures.

9/ Continuous performance criterion.

10/ Loans of zero to one year's maturity, excluding normal import-related credits converted in US dollars at actual exchange rates.

11/ Excluding arrears arising from debt-service payments that become due pending the conclusion of debt-rescheduling agreements.

12/ The NIR program and actual figures for 2004 and the NIR revised actual figure for end-2003 have been revised downward by deducting from gross reserves some deposits held by the central bank abroad which are encumbered for specific imports.

Table 2. Mozambique: Structural Performance Criteria and Benchmarks Under the 2004 PRGF Program

Actions	Expected Date of Implementation, According to the Program	Outcome
Structural performance criteria		
Submit to the National Assembly the draft general tax law (paragraph 23 of the memorandum of economic and financial policies).	End-June	Done
Strengthen the balance sheet of the Bank of Mozambique (BM) by shifting to the government a large part of its external debt liabilities, as set forth in paragraph 28 of this Memorandum and the Technical Memorandum of Understanding.	End-July	Done
Keep in place the enhanced supervisory regime for the Banco International de Moçambique (BIM), as described in the Technical Memorandum of Understanding, until approval of the financial statements for 2004 by the external auditors.	Continuous	Observed
Complete a feasibility study on the divestment of the government's participation in BIM.	End-December	Delayed until end-June 2005
Structural benchmarks		
Submit to the assembly the draft law creating the Autoridade Tributária de Moçambique.	End-July	Done August 7
Complete the revision of the regulatory framework for microfinance activities.	End-September	Done
Develop a resolution strategy for two weak small banks	End-October	Partially done
In the context of the 2005 budget, initiate the implementation of the three-year program to strengthen the balance sheet of the central bank. Include the corresponding allocation in the 2005 budget proposal.	End-October	Allocation included in the draft budget to be submitted to the assembly before end-December 2004.
Prepare the budget execution report corresponding to the third quarter of 2004 on the basis of the accounting generated by the e-SISTAFE, using the new budget classifier.	November 15	Delayed until May 15, 2005
Develop timetables to move gradually to IFRS and to comply with loan classification and provisioning, based on best international practices.	End-December	Delayed until end-February 2005
Issue regulations of the anti-money laundering law and establish financial investigations unit	End-December	Regulations already issued, but FIU has not yet been established
Implement the SISTAFE in the Ministry of Planning and Finance, including the provincial directorates	End-December	Done

Table 3. Mozambique: Structural Performance Criteria and Benchmarks through end-June 2005 Under the 2005 PRGF Arrangement

	Expected Time of Implementation
Structural performance criteria	
Issue government securities in an amount of Mt 1.5 trillion at market interest rates and transfer these securities to the Bank of Mozambique to strengthen its balance sheet.	End-June 2005
Keep in place the current supervisory regime for the Banco Internaçional de Mozambique (BIM), as described in the Technical Memorandum of Understanding, until approval of the financial statements for 2004 by the external auditors	Continuous
Structural benchmarks	
Introduce foreign exchange auctions	End-February 2005
Develop firm timetables to move gradually to IFRS in the commercial banking system and to comply with loan classification and provisioning based on best international practices	End-February 2005
Approve the internal regulations and the statute for the staff of the DGI	End-April 2005
Prepare the budget execution report corresponding to the first quarter of 2005 on the basis of the accounting generated by the e-SISTAFE, using the new budget classifier.	May 15, 2005
Rollout the SISTAFE to the Ministry of Education and abolish the disbursement of funds (adiantamento de fundos)	End-June 2005
Compile and disseminate preliminary data on the 2004 GDP by expenditure and production approach at current and constant prices, and publish a revision policy and a timetable for compiling and disseminating final national accounts data.	End-June 2005

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

January 24, 2005

1. This technical memorandum of understanding (TMU) applies from January 1, 2005. Its purpose is to describe the concepts and definitions that will be used in monitoring the Poverty Reduction and Growth Facility (PRGF)-supported program, including the following:

- government domestic primary balance;
- government revenue;
- net domestic assets, net international reserves, and reserve money of the Bank of Mozambique;
- new nonconcessional external debt contracted or guaranteed by the central 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 performance criteria of the program.

Government's domestic primary balance

2. The government's domestic primary balance is defined as government revenue, **less** noninterest current expenditure, **less** locally financed capital expenditure, **less** locally financed net lending. It excludes bank restructuring costs, the cost of recapitalizing the central bank, project expenditure, and capital expenditure financed with proceeds from the coal mining concession. 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. Unallocated revenue or expenditure arising from discrepancies between the government balance measured from above the line and the balance measured from below the line will be part of the government's domestic primary balance.

3. The 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 governments.

Government revenue, expenditure, and financing

4. **Revenue** is defined to include all receipts of the Domestic Tax Administration (Administração Tributaria de Impostos or DGI), the National Directorate of Customs (Direcção Nacional de Alfândegas, DNA), and nontax revenue, including certain own-generated revenues of districts and some line ministries as defined in the budget. Net receipts from privatization received by the National Directorate of State Assets (Direcção Nacional do Património do Estado) and unrealized profits transferred by the central bank to the treasury will not be considered as revenue (above the line) and will be accounted for as other domestic financing (below the line).

5. For the purpose of program monitoring, revenue is considered as collected at the time when it is received by the DGI from private agents or other government collecting agencies, in cash or checks, or through transfers into a DGI bank account.

6. **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. It also includes expenditure financed with the own-generated revenue of districts and some line ministries referred to above.

7. **External Financing of the Government** includes foreign grants, external loan disbursements minus amortization, changes in external arrears, and external privatization proceeds. **Domestic financing of the central government** is defined as including net financing provided by the banking system, net placements of government securities with nonbanks, and domestic privatization proceeds.

8. An indicative target consisting of **semiannual floors on the resources in the government's savings fund abroad** has been added to monitor the use of the proceeds from the signing fee for coal exploration.

Net domestic assets

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

10. The central bank's foreign currency-denominated assets and liabilities are converted in its balance sheet to meticais at actual exchange rates. However, for purposes of program monitoring, these amounts will be converted into U.S. dollars at the average program exchange rate for the end of each quarter.

11. 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, transfer of liabilities to the government, etc.

Net international reserves

12. **The net international reserves of the Bank of Mozambique** 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.

13. The Bank of Mozambique will publish the exchange rates quoted by commercial banks on average as the market rates. The exchange rates at which the Bank of Mozambique will transact foreign exchange will take as reference the rates quoted by commercial banks.

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

14. 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).

15. 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 currency-specific discount rates based on the Organization for Economic Cooperation and Development (OECD) commercial interest reference 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. This performance criterion will be assessed on a continuous basis.

Stock of short-term external public debt outstanding

16. 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. This performance criterion will be assessed on a continuous basis.

External payments arrears

17. The government undertakes not to incur payments arrears on external debt 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. This performance criterion will be assessed on a continuous basis.

Foreign program assistance

18. Foreign program assistance is defined as grants and loans received by the Ministry of Planning and Finance through Bank of Mozambique accounts (Table 1).

Actual external debt-service payments

19. 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 (Table 1).

Adjusters

20. The quantitative targets (floors) for the central bank's net international reserves will be adjusted upward (downward) for any excess (shortfall) in disbursements of foreign program assistance, compared to the program baseline; and downward (upward) to the extent that actual payments of external debt service exceed (fall short of) programmed amounts (Table 1). The quantitative targets (floors) for the central bank's net international reserves will be adjusted downward/upward for any revision made to the end-year figures corresponding to the previous year; a symmetric adjustment will apply to the ceilings on the net domestic assets of the Bank of Mozambique. They will also be adjusted upward for the full amount of any privatization proceeds in excess of those envisaged in the program, unless these proceeds are deposited in the government's savings account abroad. If they are deposited abroad, the indicative targets on the balance in this account will be adjusted upward for the full amount of the higher than envisaged proceeds, net of any costs related to the privatizations, including severance payments.

21. The quantitative targets (ceilings) for the central bank's net domestic assets will be adjusted upward (downward) for any shortfall (excess) in disbursement of external program grants and loans, compared to the program baseline; and downward (upward) to the extent that actual payments of external debt service fall short of (exceed) programmed amounts (Table 1). They will also be adjusted downward for the full amount of any privatization

proceeds in excess of those envisaged in the program, unless these proceeds are deposited in the government's savings account abroad. If they are deposited abroad, the indicative targets on the balance in this account will be adjusted upward for the full amount of the higher than envisaged proceeds, net of any costs related to the privatizations, including severance payments.

22. 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 at the end of each quarter.

23. The quantitative target (ceiling) for the domestic primary balance (excluding bank restructuring costs) for end-June 2005 and end-December 2005 will be adjusted upward (and the floors on net international reserves and ceilings on net domestic assets downward/upward) to accommodate the possible need for higher locally financed government outlays to deal with drought, up to a total limit of Mt 400 billion (US$ 18.5 million).

Data reporting

24. 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 3 of this attachment, as well as the weekly data set out in Table 4. Monthly updates will also be provided of the foreign exchange cash flow of the Bank of Mozambique, as set out in Table 5.

25. The government will continue to provide Fund staff with the data corresponding to monthly government revenues (in detail according to the fiscal table), with a lag not exceeding one month. In addition, the government will continue to publish and provide Fund staff with the quarterly budget execution reports with a time lag not exceeding 45 days.

26. In addition, the government will provide monthly information on the balance of its savings account abroad and will start developing and providing information on domestic arrears on a quarterly basis.

Enhanced Supervisory Regime for the Banco Internacional de Moçambique (BIM)

27. The enhanced supervisory regime of BIM to be kept in place by the Bank of Mozambique (BM) until the financial statements for 2004 are approved by the external auditors will include the following:

(a) Daily monitoring of BIM's liquidity position.

(b) Monitoring of monthly cash flow statements and reports on profitability, accompanied by relevant comments.

(c) Monitoring of monthly results of operational restructuring, including reductions in staff and branches, and of progress achieved by the bank's special unit in charge of collecting nonperforming loans.

(d) Prohibition of any distribution of dividends by BIM.

28. The BM will continue to share with Fund staff monthly data on BIM's financial statements, including the balance sheet, the income statement, the statement of cash flow, and the statement of changes in equity.

Table 1. Mozambique: Foreign Program Assistance and External Debt Service for 2005

(In millions of US dollars)

	2005				
	Q1	Q2	Q3	Q4	Year
	Prog.	Prog.	Prog.	Prog.	Prog.
Foreign program assistance	102.7	60.4	10.9	69.0	243.0
Program grants	102.7	60.4	10.9	9.0	183.0
Program loans	0.0	0.0	0.0	60.0	60.0
External debt service	13.4	22.0	20.5	21.0	76.8

Source: Mozambican authorities; and Fund staff estimates.

Table 2. Mozambique: External Grants and Loans in Support of the 2005 Fiscal Program

(In millions of US dollars)

	2005				
	Q1 Prog.	Q2 Prog.	Q3 Prog.	Q4 Prog.	Year Prog.
I. Grants	127.0	114.7	133.7	154.1	529.4
I.1. Projects and special program grants	22.5	52.3	113.8	141.5	330.0
Projects grants	22.5	52.3	113.8	141.5	330.0
Special program grants	0.0	0.0	0.0	0.0	0.0
I.2. Direct financing grants	1.3	1.3	9.0	3.6	15.2
I.3. Budget support grants	102.7	60.4	10.9	9.0	183.0
I.4. Food aid in kind	0.5	0.7	0.0	0.0	1.2
II. Loans	74.3	84.0	80.2	159.2	397.8
II.1. Projects loans	42.1	61.5	70.7	85.1	259.4
II.2. Loans in support of the budget					
Budget support loans	0.0	0.0	0.0	60.0	60.0
Loans for public enterprises	32.2	22.6	9.5	14.1	78.4

Source: Mozambican authorities; and Fund staff estimates.

Table 3. 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				
	Buy	Sell	Buy	Sell	Buy	Sell	BoM sales	BoM purchases	Requests outstanding for BoM foreign exchange
Monday									
Tuesday									
Wednesday									
Thursday									
Friday									

Source: Bank of Mozambique.

Table 4. Mozambique: Weekly Financial Data

Exchange rates (in meticais 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 meticais)
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 meticais)
Currency in circulation
Bank reserves
Bank of Mozambique net foreign assets
In billions of meticais
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 meticais)
Net credit to the government; flow (in billions of meticais)

Source: Bank of Mozambique

Table 5. 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

Source: Bank of Mozambique

Mozambique: Relations with the Fund
(As of October 31, 2004)

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	0.0

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

Outstanding Purchases and Loans	SDR Million	% Quota
Poverty Reduction and Growth Facility (PRGF) arrangements	130.82	115.16

Latest Financial Arrangements

Type	Approval date	Expiration date	Amount Approved (SDR million)	Amount Drawn (SDR million)
PRGF	07/06/04	07/05/07	11.36	1.62
PRGF	06/28/99	06/28/03	87.20	78.80
ESAF	06/21/96	06/27/99	75.60	75.60

Projected Payments to the Fund (with Board-approved HIPC Initiative assistance) (SDR millions; based on existing use of resources and present holdings of SDRs):

	Overdue	Forthcoming				
	10/31/04	2004	2005	2006	2007	2008
Principal	0.0	1.80	10.35	14.17	16.17	17.94
Charges/interest	0.0	0.33	0.59	0.48	0.35	0.24
Total	0.0	2.12	10.94	14.64	16.52	18.19

Implementation of HIPC Initiative:

	Original framework	Enhanced framework	Total
Commitment of HIPC Initiative assistance			
Decision point date	4/7/98	4/7/2000	
Assistance committed (end-1998 NPV terms)			
Total assistance (US$ million)	1,716.0	306.0	2,022.0
Of which: Fund assistance (US$ million)	124.6	18.5	143.1
Completion point date	6/29/99	9/20/01	
Delivery of Fund assistance (SDR million)			
Amount disbursed	93.2	13.7	106.9
Interim assistance	…	2.3	2.3
Completion point	93.2	11.4	104.6
Additional disbursements of interest income	...	1.1	1.1
Total disbursements	93.2	14.8	108.0

Safeguards Assessment

Under the Fund’s safeguards assessment policy, the Banco de Moçambique (BM) is subject to safeguards assessment with respect to the PRGF Arrangement approved on July 6, 2004. The assessment, which was completed on August 18, 2004, identified weaknesses in the areas of financial reporting, internal audit, and the system of internal controls and proposed specific measures to address weaknesses. The implementation of these measures is being monitored by staff under the PRGF arrangement.

Exchange Arrangements

Mozambique’s exchange system is a managed float. Commercial banks may buy and sell foreign exchange to individual customers on a fully negotiable basis. The Bank of Mozambique adjusts its exchange rate on a daily basis taking into account deviations from the international reserve targets. The system is currently being revised to make it more flexible to market signals.

Mozambique still avails itself of the transitional arrangements under Article XIV, but has eliminated all Article XIV restrictions. It maintains, however, restrictions on the making of payments and transfers for current international transactions subject to Article VIII, as evidenced by (i) discretionary prior approval for remittances of family living expenses; (ii) authorization for the purchase of foreign exchange in excess of US$5,000 for certain transactions; (iii) prohibition for the conversion of balances of nonresidents’ domestic currency accounts into foreign currency or transfer abroad; and (iv) proof of performance of a service prior to authorizing its payment. At the authorities' request, an Article VIII mission was conducted by LEG and PDR in March 2004. The mission encouraged the authorities to remove the exchange restrictions. The authorities indicated their intention to accept the obligations under Article VIII of the Articles of Agreement after the approval of the new foreign exchange law which is scheduled to be submitted to the assembly in 2005.

Article IV Consultation

Mozambique is on a 24-month cycle for Article IV consultations under the new guidelines for Article IV consultations, given the approval of a new PRGF arrangement in July 2004. The 2003 Article IV consultation was completed by the Executive Board on December 10, 2003 (IMF Country Report No. 04/50). At that time, the Board also considered the ex post assessment of Mozambique's performance under Fund-supported programs prepared by the staff. The next Article IV consultation is expected to be conducted during the second half of 2005.

In concluding the Article IV consultation, Executive Directors commended the authorities for their pursuit of sound macroeconomic policies and wide-ranging structural reforms over the past fifteen years, and for the satisfactory implementation of their economic program in 2002 and 2003. They welcomed the government's program for 2004 and urged the authorities to persevere with their efforts to consolidate macroeconomic stability and deepen structural reforms, with a view to sustaining growth, encouraging employment creation, and further reducing poverty. Most Directors expressed readiness to consider a successor low-access PRGF arrangement to help the authorities implement the ambitious reforms still needed.

FSAP Participation and ROSCs

A Financial Sector Assessment Program (FSAP) for Mozambique was undertaken during the first quarter of 2003. The related Financial Sector Stability Assessment was circulated to the Executive Board on November 19, 2003 (IMF Country Report No. 04/52). A Report on the Observance of Standards and Codes (ROSC) data module was prepared in June 2002 and issued on March 5, 2003. A ROSC on fiscal transparency was issued on February 22, 2001. This ROSC was updated in the context of the 2002 Article IV consultation (IMF Country Report No. 02/140) and the 2003 Article IV consultation (IMF Country Report No. 04/50).

IMF Technical Assistance Provided to Mozambique (Over the Last Two Years)				
Departments	Timing	Form	Purpose	Counterparts
Fiscal Affairs	November 2004	Inspection mission, and coordination with bilateral donors	Public expenditure management	Ministry of Finance
	October 2004	Joint IMF/SECO/ DANIDA project; short-term consultant training advisor (total 4 months in 3 visits)	Reform of the tax system and its administration	Ministry of Finance
	September 2004	Third multipartite review of the joint IMF/SECO/ DANIDA tax and customs administration reform project; inspection mission	Reform of the tax system and its administration	Ministry of Finance
	September 2004	Joint IMF/SECO/ DANIDA project: short-term advisor (total 2 months in 4 visits)	Reform of the tax system and its administration; strategic issues on the establishment of the Central Revenue Authority (visit 1 of 4)	Ministry of Finance
	July 2004	Inspection mission	Public expenditure management	Ministry of Finance
	May 2004	Mid-term review of the joint IMF/SECO/DANIDA tax and customs administration reform project	Reform of the tax system and its administration; advice on the creation of a Central Revenue Authority.	Ministry of Finance
	March 2004	Installation mission and coordination with bilateral donors	Public expenditure Management	Ministry of Finance
	October 2003	Inspection mission and coordination with bilateral donors	Public expenditure Management	Ministry of Finance
	September 2003	Joint IMF/SECO/DANIDA project; long-term consultant and training advisor mission	Reform of the tax system and its administration	Ministry of Finance
	April/May 2003	Mid-term review of the joint IMF/SECO/ DANIDA tax and customs administra-tion reform project	Reform of the tax system and its administration	Ministry of Finance
	April 2003	Inspection mission	Public expenditure management	Ministry of Finance
Legal	February 2004	Mission	Advising government on the implications of accepting the obligations under Article VIII of	Ministry of Finance, Bank of Mozambique

IMF Technical Assistance Provided to Mozambique (Over the Last Two Years)				
Departments	Timing	Form	Purpose	Counterparts
			the Fund's Articles of Agreement	
	2004	Correspondence	Advice on tax legislation	Ministry of Finance
	July 2003	Mission	Stamp tax	Ministry of Finance
Monetary and Financial Systems	October 2004	Short-term consultant	Banking supervision	Bank of Mozambique
	September 2004	Short-term consultant	Monetary operations/monetary policy	Bank of Mozambique
	September 2004	Short-term consultant	Central Bank Accounting	Bank of Mozambique
	July 2004	Short-term consultant	Banking supervision	Bank of Mozambique and Ministry of Finance
	April 2004	By correspondence	Advice on foreign exchange operations	Bank of Mozambique
	April 2004	Short-term consultant	Banking supervision	Bank of Mozambique
	March -April 2004	Mission	Banking supervision, monetary and foreign exchange operations	Bank of Mozambique
	February-March 2004	Mission	Bank restructuring	Bank of Mozambique
	October 2003	Mission	Advising on accounting issues at the central bank	Bank of Mozambique and Ministry of Finance
	September 2003	Mission	Concluding FSAP and discussion of technical assistance in the area	Bank of Mozambique and Ministry of Finance
	Mar.-Apr. 2003	Joint mission IMF/World Bank	FSAP mission follow-up	Bank of Mozambique and Ministry of Finance
	February 2003	Joint mission IMF/World Bank	FSAP mission	Bank of Mozambique and Ministry of Finance
Statistics	September 2004	Mission	Monetary and Financial Statistics	Bank of Mozambique
	May 2004	Mission	Balance of payment statistics	Bank of Mozambique
	May 2004	Mission	Consumer price statistics	National Institute of Statistics (INE)
	November 2003	Mission	GDDS mid-term review	INE
	August 2003	Mission	Balance of payments statistics	Bank of Mozambique
	May 2003	Mission	Government finance statistics	Ministry of Finance

Resident Representative: Mr. Perry Perone has been IMF's Resident Representative to Mozambique since February 1, 2003.

Mozambique: Relations with the World Bank Group
(As of October 22, 2004)

Partnership in Mozambique's Development Strategy

1. The Mozambican government's development strategy is set forth in the poverty reduction strategy paper (PRSP), termed the PARPA (Plano de Acção para a Redução da Pobreza Absoluta e Promoção do Crescimento Económico, or Action Plan for the Reduction of Absolute Poverty), which was approved in April 2001 by the Council of Ministers and endorsed in September 2001 by the Boards of the World Bank and the IMF. The PARPA focuses on six "fundamental areas" aimed at promoting human development and creating an environment for broad-based growth: macro-economic and financial management, good governance, education, health, agriculture, and basic infrastructure (roads, water, and energy). The overall perspective is that poverty can most quickly be reduced by pursuing a strategy of broad economic growth, which, in turn, is crucially dependent on the maintenance of democratic and sociopolitical stability. The government issued progress reports on the PARPA in 2003 and 2004, which restate its commitment to reduce poverty by pursuing policies that help to create an environment for broad-based growth. In addition, the Program Assistance Partners (PAPs), which include 14 donors and the World Bank, with the IMF as an observer, undertook reviews, jointly with the government, of the entire government program in March and in September 2004, using a common performance asssesment framework (PAF), in order to serve as the basis for a further shift away from project finance toward budget support. It is expected that this will streamline donor conditionality and reduce government transaction costs.

2. The Fund and the World Bank will continue to cooperate closely, within their respective mandates, in assisting the government to implement its medium-term poverty reduction and growth strategy and the related reform agenda, as presented in the PARPA and updated in the annual progress report and PAF.

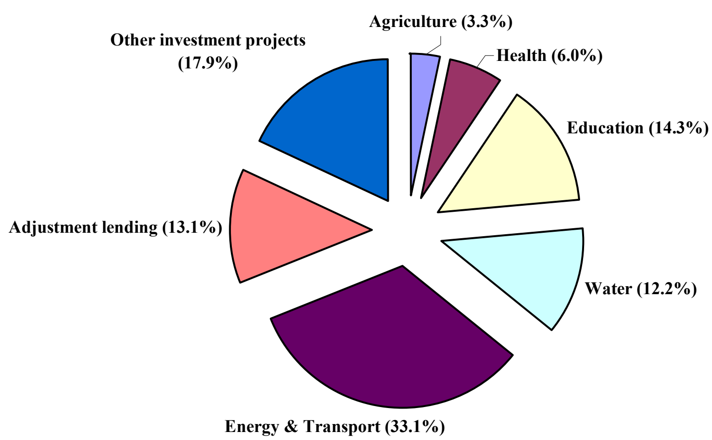
3. The Fund will continue to lead the policy dialogue on macroeconomic policy, (including fiscal, monetary, and exchange rate policies), the integrated financial management information system (SISTAFE), and tax and customs reforms. The Bank will continue to lead the policy dialogue on public expenditure management, sectoral structural reforms, and the reform of the civil service, and poverty and social impact analysis. Areas of close collaboration include banking supervision and financial sector issues, trade issues, the PARPA and its further development, and external debt sustainability.

Bank Group Country Assistance Strategy

4. The World Bank supports the implementation of the PARPA through its Country Assistance Strategy (CAS, FY 04-06). The three pillars of the CAS are (i) broadening the base of growth and ensuring its sustainability; (ii) investing in people and making services work for the poor; and (iii) improving governance and empowerment. The focus of the Bank's lending program will be on programmatic support through three rolling Poverty

Reduction Support Credits (PRSCs). Fiduciary issues are fully taken into account within the scope and sequencing of the PRSCs. The shift to programmatic lending through the PRSCs will be underpinned by the Bank's core diagnostic economic and sector work, including the public sector review and poverty and social impact analysis. While a series of PRSCs will be the largest single element in the lending program, the shift from traditional investment lending to program lending will be phased in gradually. Selected investment projects will target institutional strengthening, capacity building, transport infrastructure, water, and communications.

5. To date, the International Bank for Reconstruction and Development (IBRD) has approved 7 adjustment operations and 43 investment operations totaling approximately US$2.7 billion. The current portfolio includes 18 projects for a total of US$923 million, with an un-disbursed balance of US$744 million. Seventeen are investment projects and one is an adjustment operation which is already fully disbursed. The graph below illustrates the distribution of the current portfolio by main sectors.



6. The World Bank has been actively supporting the government of Mozambique's macroeconomic program since 1986 through a series of **structural adjustment operations**. The last, the Economic Management and Private Sector Operation (EMPSO), was approved by the Bank Board in August 2002 for US$120 million. The EMPSO supported the government's program of consolidating macroeconomic stability and laying the foundations for sustained private sector-led growth over the medium term. It includes measures to make the budget more transparent (including accounting for external aid flows), conduct a public expenditure review, strengthen the financial sector while aiming to eliminate government ownership in the sector, and liberalize the telecommunications and air transport sectors in order to facilitate further private participation. From 2004 onwards, the Bank's quick-disbursing assistance will take the form of Poverty Reduction Support Credits (PRSCs), which are being developed in tandem with the Joint Review/Performance Assessment

Framework process referred to above. The first PRSC was presented to the Board in July 2004 and was valued at US$60 million.

7. The World Bank has been an active partner in supporting the government in improving **education** and strengthening capacity building in key public institutions. The Education Sector Strategic Program (ESSP) (US$71 million—FY 99) supports the implementation of the National Education Strategy (NES). The objectives of the NES are the promotion of sustained improvements in the quality of Mozambique's labor force, and greater gender and regional equity in economic opportunities. This is complemented by the Public Sector Capacity Building Project (US$25.5 million—FY 03), which aims to increase the capacity of the government's Technical Unit for the Reform of the Public Sector (UTRESP). The Higher Education Project (US$60 million—FY 02) supports the entire higher education system, including both public and private higher education institutions. A technical and vocational education project is currently under preparation.

8. In **health**, the Health Sector Recovery Project (US$98.7 million—FY 96) supported the government's broad Health Sector Recovery Program, especially by reducing infant and child mortality. It closed in 2003 and in the future the Bank will support the health sector via the Poverty Reduction Support Credits (PRSCs) referred to above. The HIV/AIDS Project (US$55 million—FY 03) assists the government in carrying out its National Strategic Plan to Combat STDs and HIV/AIDS.

9. In the area of **transport and infrastructure**, the Bank has three active projects. The Roads and Coastal Shipping Project (ROCS II) (US$188 million—FY 94) supports the rehabilitation and maintenance of priority roads and improvements in the management capacity of roads institutions. The Railways and Ports Restructuring Project (US$100 million—FY 00) aims at increasing the operating efficiency of the three major port-rail systems in Mozambique. The Roads and Bridges Project (US$162 million—FY 02) aims at improving road infrastructure, sector policies, and management.

10. In the **water** sector, three active projects—the National Water Development Project I (NWDP I) (US$36 million—FY 98), the National Water Development Project II (NWDP II) (US$75 million—FY 99) and the National Water II Supplemental (US$10—FY04)—support improvements in service delivery standards, coverage, water resources management, and management capacity in both rural and urban areas. The NWDP II also supports contracts for the private sector management of five major cities.

11. Another important part of the Bank's portfolio focuses on strengthening the investment climate and encouraging **private sector** participation. The Private Enterprise Development Project (US$26 million—FY 00) aims at broadening the base of private participation in the Mozambican economy. The Mineral Resource Management Capacity Building Project (US$18 million—FY 01) seeks to increase institutional capacity in the sector, and alleviate poverty. The Communications Sector Reform Project (US$14.9 million—FY 02) seeks to increase private sector participation in the postal, air transport, and telecommunications sectors.

12. The Bank is also involved in **agriculture**, **energy, and the environment.** The Agricultural Sector Public Expenditure Program (PROAGRI) (US$30 million—FY 99) is a sector-wide assistance program (SWAP) that seeks to improve the impact of public expenditure in developing an enabling environment for sustainable and equitable growth in the rural sector. The Gas Engineering Project (US$26 million—FY 94), which closed in 2003, supported pre-investment in the Pande-Gas Project. The Coastal and Marine Biodiversity Management Project (US$9.7 million—FY 00) pilots an integrated approach to achieving sustainable development, focusing on two main coastal areas. Most recently, the Energy Reform and Access Project (US$40.2 million—FY 04) supports reform of the power sector, in particular the separation of distribution, transmission, and generation functions, aims at increasing the number of electricity connections and solar energy distributors, and seeks to provide capacity building to the government for negotiation of megaprojects.

13. The Bank's **proposed lending program** for FY 05 comprises a US$70 million PRSC 2, a Sustainable Tourism Project of US$20 million (grant), the Beira Rail Project of US$60 million (which was approved by the Board in October 2004), a Financial Sector Capacity of US$10 million, and a Legal Sector Capacity Project of US$5 million. In FY 06, three projects will be presented: a PRSC 3 of US$70 million, a Technical and Vocational Education grant of US$20 million, and the second phase of the Roads and Bridges APL of US$85 million.

14. The Bank's program also encompasses **economic and sector work** to support the three pillars of the CAS, involving work on the following:

- sustainable growth—an investment climate assessment, a strategy for rural growth and income creation, and a country economic memorandum on sustainable growth and poverty reduction, which will also analyze the sources of growth;

- investing in people—a country status report on health, a public expenditure review, and work on labor markets and technical education; and

- improving governance—the recently published Country Procurement Assessment Report, a legal and judicial assessment, an institutional governance review, and a Public Expenditure Management and Financial Accountability Review (PEMFAR).

IMF-World Bank Collaboration in Specific Areas

15. Fund and Bank staff maintain a close working relationship, especially with respect to (i) analyses and reforms in public expenditure management; (ii) the PARPA and accompanying annual updates and joint staff assessments; (iii) the financial sector and banking supervision; (iv) poverty and social impact analysis; (v) tax issues; and (vi) trade issues:

- **Public expenditure management**. The Fund and the Bank jointly emphasize the urgent need to further improve public expenditure management, accountability, and transparency. The two institutions support policy reforms in the areas of budget formulation, execution, and monitoring. The IMF assists the authorities in introducing the integrated financial management information system (SISTAFE), and several donors, including the World Bank, provide financial support and policy advice to this reform. Under the Fund's leadership, a group of ten donors set up a common fund for this large undertaking. The Bank's PRSC emphasizes budget comprehensiveness and budget execution reporting. The Bank and the government have worked together since September 2000 on a public expenditure review, the first volume of which was issued in December 2001 and the second in September 2003.

- **Poverty reduction strategy paper.** The Fund and Bank worked together with the government during the period 1999-2001, while the PARPA was being produced, and drafted the joint staff review, which was presented to the Board in September 2001. The government issued annual progress reports in 2003 and 2004, and the staffs presented their joint staff assessments to their respective Boards. The Fund and the Bank will continue to work jointly with the authorities as they prepare the successor program, the PARPA II.

- **Financial sector.** The Fund and the Bank have worked together on the financial sector. The banking sector in Mozambique has repeatedly shown weaknesses in the past, requiring recapitalizations and intervention. Following the Financial Sector Assessment Program (FSAP) conducted in Mozambique during the first semester of 2003, the Fund and the Bank continue to advise the authorities on strengthening financial supervision and accounting standards to prevent the recurrence of such problems in the future. A technical assistance program is under preparation.

- **Poverty and Social Impact Analysis (PSIA).** As part of the preparation for future Bank budget support and a possible successor program supported by a new Poverty Reduction and Growth Facility (PRGF) arrangement, the Fund and the Bank have agreed to review closely the poverty and social impact of the key reforms that are being implemented. A pilot PSIA, advising the government on the impact of an increase in specific fuel taxes, was undertaken in 2002. A second PSIA, on the impact of reducing primary schooling fees, was completed in October 2004. A third PSIA will be undertaken during FY05, the subject matter of which has yet to be determined.

- **Taxes.** The Fund has taken the lead in this area. The government issued a new income tax law in 2002, and a revised code of fiscal incentives for investors. The Bank has been supportive of the policies proposed. Further reforms to strengthen tax revenues and to improve the efficiency of tax administration are part of the regular dialogue with the Fund. **Trade.** The Fund and the Bank have worked together since the early 1990s on trade issues concerning general reductions in tariffs, the variable tariff on sugar introduced in 1999, and the reduction in the export tariff on raw cashews. The Fund and the Bank are involved in reforming the customs administration in Mozambique. The Bank is cooperating with the donors (particularly USAID) and the government in executing the studies on trade policy required for the Integrated Framework.

16. Over the next three years (2005-07), disbursements under World Bank investment projects are expected to reach around US$125 million on average per year. Under the Country Assistance Strategy (CAS), World Bank support to Mozambique will focus on agriculture, education, infrastructure, the financial sector, capacity building, and public sector reform.

World Bank Loan and Grant Operations, 1999-2005 [1]
(In millions of U.S. dollars)

	1999	2000	2001	2002	2003	2004	2005
		Actual				Est.	Proj.
I. Project Credit Disbursements	79.4	97.5	51.6	85.2	89.4	120.0	125.8
Established operations							
Household Energy (6/89) [2/]	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Economic and Financial Management (10/89)[2]	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Education II (12/90)[2/] 2/	2.5	0.0	0.0	0.0	0.0	0.0	0.0
Industrial Enterprise (12/89)[2]	7.6	2.0	0.0	0.0	0.0	0.0	0.0
Agricultural Service Rehabilitation Development (2/92)[2]	2.5	0.7	0.0	0.0	0.0	0.0	0.0
First Road and Coastal Shipping (6/92)[2]	12.5	4.0	0.0	0.0	0.0	0.0	0.0
Capacity Building: Human Res. Dev. (11/92)	11.3	4.5	2.8	0.0	0.0	0.0	0.0
Capacity Building: Public Sector & Legal Institutional Development (11/92)	0.9	0.7	0.0	0.0	0.0	0.0	0.0
Maputo Corridor (1/93)[2]	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Rural Rehab.(3/93)[2]	3.8	2.0	0.3	0.0	0.0	0.0	0.0
Food Security (4/93)[2]	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Local Government (6/93)[2]	3.1	0.0	0.0	0.0	0.0	0.0	0.0
Second Road and Coastal Shipping (4/94)[2]	16.9	26.5	11.4	9.7	17.5	0.0	0.0
Financial Sector Capacity Building (4/94)[2]	2.0	1.4	0.3	0.0	0.0	0.0	0.0
Gas Engineering (6/94)[2/] 2/	1.5	1.1	1.6	1.8	0.4	0.0	0.0
Health Sector Recovery (11/95)[2]	12.0	17.2	17.4	14.4	5.6	0.0	0.0
National Water I (2/98)	1.3	1.7	2.4	3.9	4.5	6.0	6.0
Agricultural Sec. PEP (2/99)	0.5	0.9	4.2	3.8	3.9	4.0	0.0
General Education (2/99)	1.0	0.5	1.2	6.9	14.7	18.0	15.0
Railway and Port Restructuring (10/99)	0.0	1.9	3.6	22.3	8.2	16.0	12.0
National Water II (6/99)	0.0	1.4	2.8	4.4	5.1	5.0	6.0
Enterprise Development (01/00)	0.0	2.3	3.0	2.9	3.4	4.0	4.0
Flood Emergency Recovery (4/00)	0.0	28.7	-0.2	0.0	0.0	0.0	0.0
Coastal and Marine Biodiversity (6/00)	0.0	0.0	0.3	0.4	0.3	1.0	1.0
Newest operations							
Municipal Development (7/01)	0.0	0.0	0.3	4.3	4.6	5.0	7.0
Roads and Bridges I (7/01)	0.0	0.0	0.0	4.3	0.5	28.0	30.0
Communications (11/01)	0.0	0.0	0.0	1.2	2.8	2.5	3.0
Mineral Resources Project (3/01)	0.0	0.0	0.2	1.4	4.1	6.0	2.3
Higher Education Project 1 (3/02)	0.0	0.0	0.0	3.4	9.2	10.0	10.0
HIV/AIDS (3/03)	0.0	0.0	0.0	0.0	2.7	3.0	5.0
Public Sector Reform (3/03)	0.0	0.0	0.0	0.0	1.2	3.0	5.0
Energy Reform and Access Project (8/03)	0.0	0.0	0.0	0.0	0.0	3.0	10.0
Decentralization Planning (11/03)	...	...	...	...	...	5.0	8.0
National Water II Supplemental(2/04)	0	0	0	0	0	0.5	1.5
II. Adjustment operations	150.0	0.0	0.0	63.5	70.7	60.0	70.0
Economic Management Reform Operation (12/98)[2 3]	150.0	0.0	0.0	0.0	0.0	0.0	0.0
Economic Management and Private Sector Operation	0.0	0.0	0.0	63.5	70.7	0.0	0.0
PRSC 1 (06/04)	...	...	...	...	...	60.0	...
PRSC 2	...	...	...	...	...	...	70.0

[1] Date of Board approval in brackets.

[2] Closed.

[3] Grant.

Mozambique: Statistical Issues

1. Against the background of a weak and deteriorating statistical infrastructure, Mozambique has made great efforts to rebuild its statistical system with assistance from the Fund, the World Bank, and donors. However, much remains to be done to improve the coverage, accuracy, and timeliness of macroeconomic statistics.

2. The data module of the Report on Observance of Standards and Codes (ROSC) for Mozambique, published in March 2003, includes a detailed assessment of the quality of the country's macroeconomic statistics. The report concludes that there is a need for improvements in several areas, including the national accounts, prices, and the government finance and balance of payments statistics.

3. The authorities are committed to adhering to internationally accepted standards and good practices, as demonstrated by their participation in the IMF's General Data Dissemination System (GDDS) and, in particular, in the GDDS Regional Project for Lusophone African Countries. The Project's Regional Advisor and national accounts advisor has been stationed in Maputo since October 2002. Mozambique metadata are posted on the IMF's data dissemination website, and also on the National Institute of Statistics' (NSI) website. In August 2004 the NSI´s webpage was replaced by a portal with search capabilities that substantially improved the accessibility to the data and metadata disseminated.

National accounts

4. The national accounts are prepared by the NSI. Revised series starting in 1991 have been compiled in accordance with the *System of National Accounts1993 (1993 SNA*). The NIS compiles and disseminates (i) annual GDP at current and constant (1996=100) prices by activity; (ii) annual GDP by expenditure items at current and constant prices; (iii) annual value-added components at current prices by activity. Annual accounts by institutional sectors were published for 1996 and 1997; NSI is preparing the sector accounts and the economic integrated accounts for the following years, planned to be published on the first quarter of 2005. The 2002 ROSC data module assessment identified weaknesses in the accuracy and reliability of the national accounts source data. The NIS has been undertaking new household surveys and sectoral censuses in order to start compiling a new benchmark year (2003) with new and improved data sources and methodology. The new national accounts framework will also include compilation of quarterly estimates expected to start being disseminated by mid-2006. The IMF is providing technical assistance in national accounts in the context of the GDDS project.

Prices and labor market

5. As of February 2000, a new consumer price index (CPI) for Maputo, based on weights revised on the basis of the 1996-97 household survey, was implemented. Consistent time series are available starting from 1995. However, the concentration of the weights on a few basic food staples with relatively volatile prices makes the CPI prone to significant swings. A preliminary national index obtained by integrating the indices for Maputo, Beira, and Nampula has been published. The NSI is preparing a new CPI, based on the results of the

Household Budget Survey 2002/03. The new CPI series is planned to start being disseminated in May 2005. The IMF is providing technical assistance in price statistics in the context of the GDDS project, and a first mission took place in May 2004.

6. There are very little sectoral labor market and employment data, and, where available, they have limited coverage. A one-year labor market survey was launched in October 2004 covering all the country; and NSI expects to have the first data about mid-2005. This survey is undertaken by NSI in collaboration with the Labor Ministry.

Monetary accounts

7. An STA mission visited Mozambique in September 2004 to support a work plan for the implementation of the *Monetary and Financial Statistics Manual* (*MFSM*) and the development of an integrated database that covers the needs of the Bank of Mozambique, AFR, and STA. The mission acknowledged the progress achieved in the information technology system, and in the periodicity and timeliness of the compiled data. However, the mission found that the chart of accounts of the Bank of Mozambique is inadequate to obtain a proper sectorization and to distinguish between local and foreign-currency-denominated accounts. The mission recommended improvements in the classification and valuation of some financial instruments, as well as to expand the coverage of the survey on other depository corporations by including the credit cooperatives. The mission also recommended to update the GDDS metadata and to improve data accessibility to users through the Statistical Bulletin of the Bank of Mozambique.

Statement by the IMF Staff Representative
February 11, 2005

The following information has become available since the issuance of the documents relating to the first review under the three year arrangement under the Poverty Reduction and Growth Facility. The thrust of the staff appraisal remains unchanged.

1. On February 2, 2005, Mr. Guebuza of FRELIMO (the ruling party) was inaugurated as President of the Republic. During his speech, the President highlighted that his government would honor commitments with multilateral and bilateral partners, including those with the Fund. President Guebuza appointed Ms. Luisa Dias Diogo, who served as Prime Minister and Minister of Planning and Finance under the previous FRELIMO administration, as Prime Minister, and Mr. Manuel Chang, previously Deputy Finance Minister, as the new Minister of Finance. Minister Chang reiterated the government's commitment to the PRGF-supported program and the current orientation of economic policies in a meeting with the Fund Resident Representative in Maputo.

2. The 12-month rate of inflation declined to 7.6 percent in January 2005, from 9.1 percent in December 2004. The metical has continued to strengthen against the U.S. dollar; the cumulative appreciation from end-2003 to end-January 2005 exceeded 20 percent.

3. The information on the government's fiscal performance for the whole year 2004 is still incomplete, as the authorities provide quarterly data on budgetary execution with a lag of 45 days. Partial information on the financing of the budget suggests that the domestic primary deficit was lower than in the revised fiscal projection reflected in the staff report. Preliminary revenue data, however, indicate that revenue performance remained weak during the last quarter of 2004; total revenue for the year was 0.6 percentage point of GDP lower than envisaged in the staff report owing to further shortfalls in the personal and corporate income taxes and customs receipts. These developments suggest that expenditure was restrained significantly below program projections, which may have affected adversely the priority sectors. No information is yet available on expenditure and its composition.

4. Preliminary monetary information indicates that the end-December 2004 performance criteria on the net international reserves (NIR) and net domestic assets of the Bank of Mozambique (BM) were observed with large margins. Reserve accumulation was much larger than programmed during the last quarter of 2004, owing to continued strong inflows of private capital. As a result, NIR rose by US$225 million during 2004, to US$963 million by year's end, or about US$200 million more than the adjusted program target. Notwithstanding the much larger reserve accumulation, the indicative target for base money was exceeded by a relatively small margin, owing mainly to a larger-than-expected reduction in the net indebtedness of the government with the Bank of Mozambique. In light of the decline in inflation and the continued pressures toward an appreciation of the metical, in mid-January 2005 the Bank of Mozambique lowered its lending and absorption interest rates further by 200 basis points, to 11½ percent and 4½ percent, respectively.

5. As regards developments on the structural front, the supervisory regime for the Banco Internacional de Moçambique (BIM) has been kept in place, with the monthly information on the bank's financial statements through end-December 2004 showing that BIM remains profitable and in compliance with prudential requirements. The authorities have also informed the staff that the audits of the other large banks based on International Financial Reporting Standards (IFRS) have been completed, and that the final reports will be made available to them shortly. A Fund expert is currently in Maputo to help prepare a timetable for the transition to IFRS by the BM.

6. In January, with technical assistance from a Fund expert, the BM initiated its auctions of foreign exchange, in line with program understandings. The auctions are held once a week, and in between auctions the BM intervenes in the interbank market as required.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 05/27
FOR IMMEDIATE RELEASE
February 11, 2005

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes First Review Under the Three-Year PRGF Arrangement for Mozambique and Approves US$2.4 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the first review of Mozambique's economic performance under an SDR 11.36 million (about US$17.1 million) Poverty Reduction and Growth Facility (PRGF) arrangement (see Press Release No. 04/153).

The completion of the review enables the release an amount equivalent to SDR 1.62 million (about US$2.4 million), which will bring total disbursements under the PRGF arrangement to an amount equivalent to SDR 3.24 million (about US$4.9 million).

The Executive Board approved a three-year arrangement under the PRGF for Mozambique on July 6, 2004 to support the country's economic reform program into 2006.

Following the Executive Board's discussion on Mozambique's economic performance, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, stated:

"Mozambique's economic performance under the PRGF-supported program continued to be satisfactory during 2004. Real GDP growth has remained strong; inflation has declined to single-digit levels; and the international reserve position has further strengthened. Progress has also been made on the structural front, notwithstanding some delays related in part to capacity constraints, and in reducing the still high levels of poverty.

"The authorities are continuing to maintain a prudent fiscal stance, but need to promptly address the recent weakening of the revenue performance. The successful launching of the new financial administration system (SISTAFE) in the Ministry of Finance is regarded as an important step toward increasing fiscal transparency and strengthening public expenditure management.

"The government's program for 2005 seeks to sustain rapid growth, consolidate the gains toward price stability, and deepen structural reforms. Achieving the program's primary deficit target will require strong efforts to strengthen tax revenue, as well as close monitoring of the government's wage bill and restraint in non-priority outlays. The authorities are moving ahead with the steps required to establish a Central Revenue Authority and with a comprehensive public sector reform program supported by the World Bank.

"The Bank of Mozambique will maintain a prudent monetary stance in the context of the current managed float exchange rate system. The program envisages further measures to improve liquidity management and strengthen the balance sheet of the Bank of Mozambique.

"The authorities remain committed to strengthening the financial system, fostering a healthy competitive environment, and expanding access to financial services by the poor. The recent completion of the diagnostic reviews of the major banks constitutes an important step in this regard. Sustained efforts in this area, further progress in reducing the cost of doing business and easing labor market rigidities, and improvements in governance and the judicial system will be key to stimulating private sector development, sustaining strong growth, and further reducing poverty. Mr. Kato stated.

The PRGF is the IMF's concessional facility for low-income countries. PRGF-supported programs are based 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 payment.

Statement by Peter Ngumbullu, Executive Director for Republic of Mozambique and Yasmin Patel, Senior Advisor to Executive Director
February 11, 2005

1. The Mozambican authorities are in broad agreement with the staff's assessment of Mozambique's recent economic performance under the PRGF arrangement, approved by the Board in June 2004. They share staff's views regarding the challenges still facing the country and the need to continue to adapt macroeconomic and structural policies to meet those challenges.

Recent Developments

2. In the political arena, the third Presidential and Parliamentary elections were held in early December 2004, reflecting further entrenchment of the democratic system initiated more than a decade ago. Mozambique also witnessed for the first time in its history a normal transition in political leadership, following former President Chissano's decision not to contest these elections. A new Constitution, containing amendments, modernizing and expanding the country's basic law, was approved in November 2004. The new Administration, which took office in early February 2005, has stated its unwavering political commitment to sustaining the momentum of economic reforms, underpinned by greater operational efficiency and pursuing an unrelenting fight against the still widespread poverty.

3. The Mozambican institutions demonstrated their ability to further political and economic stability and to maintain business confidence in the period leading to these general elections. Economic performance remained satisfactory during 2004 and all quantitative and structural performance criteria were observed. The economy continued to record a strong growth, albeit at a slightly slower pace of about 8 percent, compared to 8.4 percent envisaged in the program, due to slower activity in the construction sector. The overall growth was supported to a reasonable extent, by the expansion of the aluminum smelter and the coming into operation of the gas pipeline megaproject, but also by the significant expansion in the manufacturing, services, and transport and communications sectors, which have continued to enhance the economy's supply response. Inflationary pressures abated significantly compared to 2003, as reflected by the decline in the end-year consumer price inflation to 9.1 percent, well below the program's objective of 11 percent. According to latest information, inflation continues to decline steadily and in January 2005, the 12-month rate of inflation stood at 7.6 percent. Despite pressures on the budget that arose from shortfalls in revenues associated with, among other factors, the impact of the currency appreciation on customs collections and delays in collecting corporate income tax, the end-September 2004 indicative target on the domestic primary deficit was missed only by a very small margin, as the revenue underperformance was promptly offset by cutbacks in expenditure, especially in nonpriority areas. Monetary policy was kept tight, which helped to contain monetary expansion at 12 percent, 3 percentage points below the program projection. The persistence of abnormally high commercial banks' lending rates, however, remain a matter of major concern to the authorities, but they are confident that both the legal reforms under way and

the rationalization of operational costs will lead the interest rates to drop, in the long-term. Aided by a buoyant export performance, largely influenced by the megaprojects, the external current account position has strengthened significantly, with the country maintaining a comfortable cushion in foreign reserves. Several structural reforms were implemented, particularly in the fiscal area and in the financial system, although short delays occurred in complying with few structural benchmarks, mainly because of capacity constraints.

The Economic Program for 2005

4. As can be seen from the authorities' Memorandum of Economic and Financial Policies, the program is focused on the need for consolidating macroeconomic stability and achieving further progress on structural reforms in several important areas. The broad strategy aims at sustaining high rates of economic growth, promoting employment creation, and further reducing poverty. To achieve these, the authorities' immediate policy efforts will be directed to enhancing revenue, improving expenditure efficiency, strengthening the banking system, and promoting private sector development.

Fiscal Policy

5. The strengthening of the fiscal position remains a critical element of the program and the authorities are committed to reducing the primary deficit to 3.3 percent of GDP. The authorities recognize that enhancing revenue performance remain an important challenge. To this effect, in addition to incorporating into the budget all previously off-budget revenue, efforts are being intensified to strengthen tax administration, improve the effectiveness of enforcement practices, particularly the collection of the new corporate income tax, and speed up computerization to support tax collection. Moreover, the creation of the Central Revenue Authority will help to ensure a better coordination among revenue agencies, while improving monitoring of collection and audit activities. As a result of these measures, revenue is projected to increase to 14.9 percent of GDP in 2005 and 15.3 percent in 2006.

6. The authorities intend to maintain tight control over expenditure, while making room for increased spending for the priority sectors identified in the PARPA. As a result, the share of resources allocated to poverty reduction programs is expected to increase from 65 percent of total primary expenditure in 2004 to 67.3 percent in 2005. The wage bill is projected to decline slightly to 7.4 percent of GDP in 2005, as the average general wage increase for civil servants is expected to be contained to 6.5 percent, which is well below the projected inflation rate for the year. This restraint in wage increases will make room for recruitment of additional employees for priority sectors. The authorities are also determined to further strengthen budget management to increase transparency and efficiency. In this connection, an important step has been taken by initiating the implementation of a new financial administration system (SISTAFE) in the Ministry of Finance, in November 2004, which is expected to be progressively rolled out to all line Ministries, starting with the Ministry of Education.

Monetary Policy

7. In the monetary area, the authorities are committed to a stance consistent with maintaining the downward trend in inflation. The monetary program makes room for credit expansion to the private sector in line with the nominal GDP. The authorities are making increased use of sales of foreign exchange to improve liquidity sterilization thus reducing reliance on costly domestic instruments. The central bank remains, however, committed to limit intervention in the foreign exchange market to achieving the international reserve targets. As part of several measures envisaged to strengthen exchange rate management, Banco de Moçambique (BM) has already introduced in early January 2005, a foreign exchange auction system, which was initially envisaged for end-February. In its commitment to strengthening the balance sheet of the central bank, the government will be securitizing its obligations to the bank that will help to improve its financial position. It also provides the BM a portfolio of securities that could be used to smoothen monetary conditions. The authorities are also determined to continue to work towards enhancing the efficiency of the financial system and improving prudential supervision.

Structural Reforms

8. Despite the wide-range of structural reforms already implemented, the authorities intend to maintain the momentum of these reforms, which are necessary to underpin increased efficiency in the economy. Hence, they are actively pursuing policies that will further encourage private sector development, given its importance as the engine of growth and employment creation. In this regard, they are aware of the need to reduce the cost of doing business in Mozambique and have taken several measures to address this problem. The measures include, continued work on reducing red tape for the registration of new companies, adoption of new regulations simplifying inspection procedures, the establishment of one-stop shops for business registration, and streamlining the licensing of commercial activities. The labor law is also in the process of being revised with a view to increasing flexibility in the labor market by reducing retrenchment costs and facilitating temporary employment. In addition, further progress has been made in the implementation of the public sector reform, with the completion of the functional analysis of six major ministries. A study is currently being carried out to determine the appropriate size of the public service and reform the wage system with a view to linking remunerations to performance. The authorities remain committed to reforming the judicial system but resource and capacity constraints have not allowed them to advance in these reforms at the desired pace. The authorities are also fully cognizant of the need to revise land tenure regulations to facilitate the use of land as bank collateral. However, they are of the view that given the sensitivity of the issues involved, ensuring a broad political consensus before any reform is introduced in this area, is indispensable. They are hopeful that the planned Poverty and Social Impact Analysis (PSIA) study, to be carried out during 2005, on land tenure regulations and their implications for accessing bank financing will provide useful insights that will facilitate their decision on the matter.

Conclusion

9. In concluding, we would like to convey the Mozambican authorities' profound appreciation to the Fund management and staff for their invaluable assistance, in terms of policy advice, technical assistance and financial support as well as cooperation extended over several years. They look forward to maintaining the productive relations and the support they have enjoyed from the Fund and the international community, which will continue to play a key role, as in the past, in assisting the authorities to meet the many economic challenges that still lie ahead.