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Republic of Mozambique: Fourth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Financing Assurances Review, and Request for Modification of Performance Criteria—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 fourth review under the three-year arrangement under the Poverty Reduction and Growth Facility, financing assurances review, and request for modification of performance criteria, the following documents have been released and are included in this package:

- the staff report for the Fourth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Financing Assurances Review, and Request for Modification of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on April 4, 2006, with the officials of the Republic of Mozambique on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 1, 2006. 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 June 16, 2006 updating information on recent developments.

- a Press Release summarizing the views of the Executive Board as expressed during its June 19, 2006 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*
Technical Memorandum of Understanding*
*Also included in Staff Report

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF MOZAMBIQUE

Fourth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Financing Assurances Review, and Request for Modification of Performance Criteria

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

Approved by David Nellor and Anthony Boote

June 1, 2006

- Discussions for the fourth review under the Poverty Reduction and Growth Facility (PRGF) arrangement were held in Maputo during March 21–April 4, 2006 by a staff team comprising Messrs. Clément (head), Peiris, Lledó, and Hartley (all AFR), and Ms. Oomes (PDR). Mr. Kanu (OEDAE) also participated in the meetings. The team was assisted by Mr. Fischer, the Resident Representative in Mozambique. Mr. Binkert (World Bank) joined the discussions and Ms. Geginat (World Bank) assisted with the joint Debt Sustainability Analysis (DSA). The mission overlapped with a World Bank Group mission advising on the financing options for the Cahora Bassa dam, and benefited from recommendations of a recent Fund Technical Assistance (TA) mission on the reform of the tax system. The mission met with the Ministers of Finance, Development and Planning, Justice, Mining, Energy, Education, Health, and Trade and Industry, the Governor of the Bank of Mozambique, and senior government officials. The mission coordinated its work with a Joint Review of Program Aid Partners (PAPs) including the World Bank.
- The attached letter of intent (LOI) and memorandum of economic and financial policies (MEFP) from the Minister of Finance and Governor of the Bank of Mozambique (Appendix I) review the performance under the PRGF arrangement during October 2005-March 2006, and set out the policies and program monitoring issues for the remainder of 2006. The authorities are requesting changes to the performance criteria on the domestic primary deficit and net domestic assets (NDA) for end-June 2006, as part of a streamlining of quantitative performance criteria and adjustors under the program as defined in the technical memorandum of understanding (TMU).
- The new government that took office in early 2005 has shown a strong commitment to implement and monitor the PRGF-supported program. The structural reform agenda articulated in the *Plano de Acção para Redução da Pobreza Absoluta* II (PRSP II or "PARPA II" in Portuguese) for 2006–09 that will soon be submitted to the World Bank and Fund by the Government includes the launching of a "second wave of reforms." As a result, donor support is expected to remain strong.

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EXECUTIVE SUMMARY

- **Macroeconomic performance has remained strong in 2005.** Despite a drought that affected parts of the country and the spike in global oil prices, real GDP growth is expected to have remained at around 7½ percent while headline inflation moderated, albeit with a rise in the last few months of the year. As expected, the external current account deficit, excluding grants, widened due to a rise in cereal and oil imports, but international reserves remained comfortable, reflecting an increase in donor inflows.

- **Performance under the program was satisfactory in 2005.** All quantitative performance criteria were met through end-December, although the structural benchmark for end-December 2005 was missed. The two structural benchmarks for end-March 2006 were implemented with a slight delay. Preliminary data show that all indicative quantitative targets for end-March have been met except for reserve money.

- **The stabilization effort was underpinned by a better-than-programmed fiscal consolidation.** The domestic primary deficit narrowed by nearly 2 percent of GDP in 2005 (nearly 1 percent of GDP better than programmed) compared to 2004, explained by 1½ percent of GDP rise in domestic revenue and expenditure restraint. Importantly, the share of priority expenditure remained above the PARPA target.

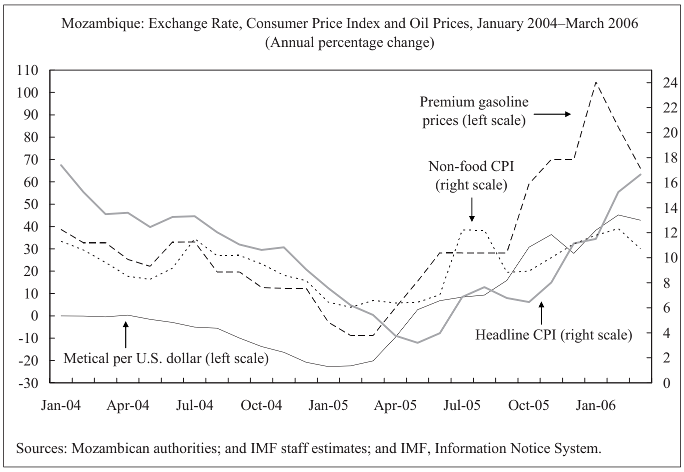
- **The consolidation of macroeconomic stability and sustaining broad-based growth through prudent macroeconomic policies is a key pillar of PARPA II.** Central to this strategy will be a gradual strengthening of the fiscal position underpinned by an average increase in revenue of 0.5 percent of GDP per annum, and public expenditure management reforms targeted at "priority" sectors to secure better value for money including MDRI resources. Monetary control will anchor inflationary expectations in the context of a flexible exchange rate regime that helps cushion against exogenous shocks and maintain a comfortable level of international reserves.

- **The outlook for 2006 is favorable, albeit with downside risks related to oil prices.** Real GDP growth is expected to increase to nearly 8 percent while the monetary program aims to control inflationary pressures stemming from exogenous shocks. A continued rise in domestic petroleum prices constitutes a downside risk to the inflation target and trade deficit. The fiscal framework for 2006 includes additional "priority" expenditure identified in the budget that was contingent on the implementation of the MDRI. The external current account deficit is likely to narrow thanks to a scaling-up of official transfers while international reserves remain at comfortable levels.

- **The PARPA II includes the launching of a "second wave of reforms" to sustain broad-based growth and help achieve the Millennium Development Goals (MDGs).** In the fiscal area, reforms will focus on establishing the Central Revenue Authority (ATM), the rollout of e-SISTAFE (Financial Administration System) to all tiers of government, and reinvigorating the public sector reform program. The structural program also aims at improving governance and reducing the costs of doing business as well as strengthening the transparency of natural resource management and megaprojects.

I. A Resilient Economy Supported by Prudent Macroeconomic Policies

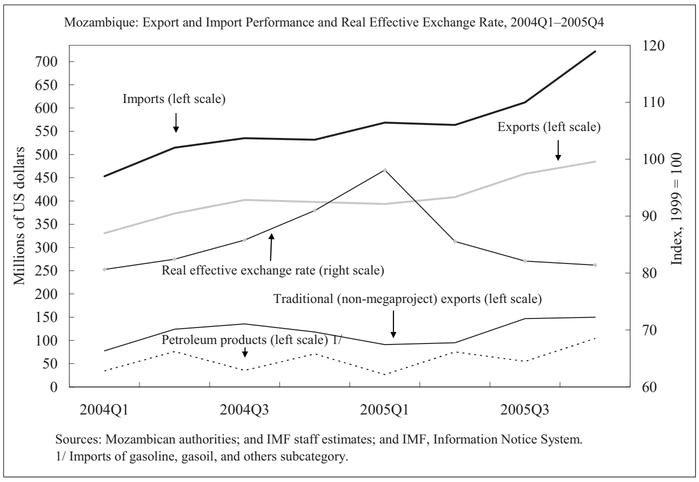
1. **The economy continues to perform well in spite of exogenous shocks.** Real GDP growth is expected to have remained at around 7½ percent in 2005 led by the construction, mining, communication and transport sector (Figure 1). However, the drought and flooding in 2005 demonstrated that Mozambique remains vulnerable to meteorological risks. While the annual average headline inflation rate moderated from 12.6 percent in 2004 to 6.4 percent in 2005 (from 9.6 percent to 8.5 percent for nonfood inflation), it accelerated in the last few months due to the spike in domestic petroleum prices, higher food prices and pass-through of the exchange rate depreciation in late 2005 (Figure 1).[1]



Mozambique: Exchange Rate, Consumer Price Index and Oil Prices, January 2004–March 2006
(Annual percentage change)

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

2. **Despite a strong growth in exports, the trade deficit widened contributing to depreciation pressures on the exchange rate.** In 2005, exports grew by 16.1 percent in U.S. dollar terms; of which 14.2 percentage points were contributed by megaprojects (e.g., aluminum, electricity, and natural gas). On the other hand, imports grew by more than 20 percent driven mainly by higher cereal and petroleum imports related to the drought and oil price shock. The increase in demand for foreign exchange driven by changes in leads and lags of export and import payments as well as somewhat lumpy oil import transactions and portfolio shifts in a thin market contributed to a reemergence of exchange rate depreciation pressures in last quarter of 2005. In response to mounting exchange rate volatility, the Bank of Mozambique (BM) temporarily introduced an exchange rate band in the interbank foreign exchange market in



Mozambique: Export and Import Performance and Real Effective Exchange Rate, 2004Q1–2005Q4

Sources: Mozambican authorities; and IMF staff estimates; and IMF, Information Notice System.
1/ Imports of gasoline, gasoil, and others subcategory.

[1] Based on the new Maputo consumer price index (CPI) where the weight of food items was revised downwards from 62.4 to 51.9 percent in line with household survey of 2002/03.

November 2005. The net international reserve (NIR) target for end-December 2005 (above 4½ months of imports) was met and most of the real effective appreciation of the metical in 2004 was reversed in 2005 (Figure 2).

3. **The stabilization effort was underpinned by a better-than-programmed fiscal consolidation.** The domestic primary deficit narrowed by nearly 2 percent of GDP in 2005 (nearly 1 percent of GDP better than programmed) relative to 2004 (Table 2). This was explained by an almost 1½ percent of GDP rise in domestic revenue effort led by the buoyancy of corporate tax collections and a substantial rise in nontax revenues, including megaproject dividends. Current and locally financed investment expenditures were lower than programmed due to the late approval of the budget following the elections in December 2004. The share of priority expenditures was above the 65 percent PARPA target, of which 55 percent was spent on the education and health sectors (Table 6).

4. **Progress continues to be made on the fiscal structural agenda** (MEFP, paragraphs 4 and 5). The establishment of the ATM with better resources and systems in 2006 is on track with the recent passage of the ATM law and regulations now under preparation. The pilot rollout of e-SISTAFE to the Ministry of Education and Culture by end-December 2005 was implemented in November but the disbursement of funds *(adiantamento de fundos)* were not fully eliminated as envisaged initially (structural benchmark for end-December 2005) because full functionality of the system was delayed until July 2006 due to technical difficulties in the development of the new version of the e-SISTAFE software. Donor-financed projects are starting to be integrated gradually into the e-SISTAFE but the level of off-budget projects remains high and these projects are characterized by reporting difficulties and relatively low execution rates. In the area of decentralization, the government approved regulations to the Local State Entities Law (LOLE) that confers a central role to districts in the planning process and in local development, including the introduction of an investment budget. A new public procurement code in line with international standards was also approved but a strengthening of internal and external audit capacity is needed to reinforce the integrity of fiscal operations.

5. **Credit to the economy accelerated.** The PC on NDA was met for end-December 2005 but broad money was higher than programmed due to greater-than-anticipated net foreign assets and stronger growth in credit to the economy (Table 3). Reserve money growth was within its indicative target for end-December. The recorded increase in credit to the economy seems to have been driven by borrowing by domestic petroleum distributors related to the syndication of oil import transactions, the

Mozambique: Sectoral Contribution to Credit Growth 1/ , 2005

	Jun.	Dec.
Economic Activity	(In percent of total credit growth)	
Agriculture	10.9	9.8
Industry	14.6	2.4
of which : Tourism	6.7	4.7
Construction	5.5	5.2
Commerce 2/	29.9	42.2
Transport and Communications	-0.1	5.1
Other	39.2	35.3
of which : Private 3/	11.9	14.6
Total	100	100
Memorandum Items :		
Credit Growth- Monthly Credit Survey	25.3	56.6
Credit Growth -Monetary Survey	24.9	57.0

Source: Bank of Mozambique (BM).

1/ Total and sectoral growth relative to December 2004 and based on BM's Monthly Credit Survey. This survey covers only a sample of the universe of financial institutions covered in BM's monetary survey.
2/ Includes all loans to finance domestic and foreign trade activities such as oil and food imports.
3/ Includes credit cards and consumer credit lines for vehicle and durable goods.

inclusion of the operations of a leasing company purchased by Banco Internacional de Moçambique (BIM) in the monetary survey since December (accounting for about 7 percent of total domestic credit) and, in part, due to structural factors associated with banks resuming consumer credit (e.g. credit cards, loans to purchase durable goods) following the completion of their restructuring plans that have resulted in healthier balance sheets.

6. **The balance sheet of the BM was strengthened, while prudential ratios of the banking system continue to improve** (Table 7). The net financial losses reported by the BM in 2004 were compensated by a healthy gain in 2005 and supported by the issuance of Mt 1.5 trillion government securities to the BM in June. The ratio of nonperforming loans to total loans has fallen below 5 percent for the first time while, since July 2005, commercial banks are required to provision 50 percent of their foreign currency-denominated loans to nonexporters which has resulted in a decline in the ratio of foreign exchange loans to total loans.

7. **Progress on the structural front was slower than envisaged** (MEFP, paragraph 8). The new labor law is yet to be approved and the adoption of the revised anti-corruption strategy by the Council of Ministers was delayed by a month (a structural benchmark for end-March 2006). However, notable advances were made in legal reform with the approval of the new Commercial Code, the Commercial Registration Code, and the Civil Procedure Code in December 2005 while commercial sections in the judicial tribunals of the city of Maputo were also established. Challenges remain, however, to substantially improve access to justice for all citizens.

8. **Performance under the program was satisfactory in 2005.** All quantitative performance criteria for end-2005 have been met while the structural benchmark for end-December was missed (MEFP, Tables 1 and 2). The two structural benchmarks for end-March 2006 were not met but implemented with a slight delay (MEFP, Table 2). Preliminary information shows that all quantitative indicative targets for end-March 2006 have been met except for the reserve money target. In the area of monitoring and evaluation, the development of the PARPA II was a notably consultative process supported by the strengthening of the participatory poverty monitoring process, through national and provincial poverty observatories.

II. Policy Framework

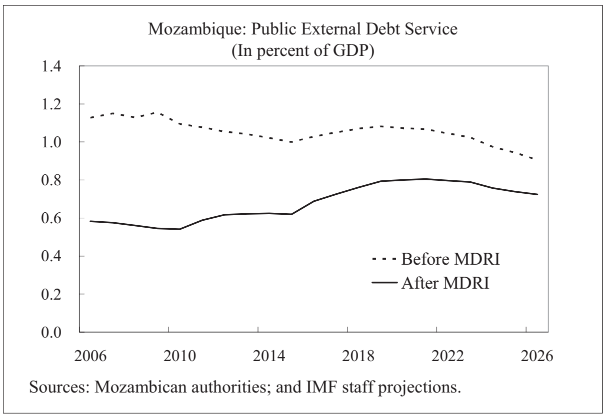
A. PARPA II and Medium-Term Macroeconomic Framework

9. **The PARPA II includes the launching of a "second wave of reforms" to sustain broad-based growth and help achieve the MDGs.** This involves a two-pronged strategy to (i) consolidate macroeconomic stability through a gradual strengthening of the fiscal position to increase credit to the private sector and maintain a competitive exchange rate while monetary restraint helps anchor inflationary expectations, and (ii) institutional reforms and good governance to buttress the investment climate and ease the constraints on growth. A

strengthening in transparency of natural resource management and megaprojects will also be critical by adhering to the principles of the Extractive Industries Transparency Initiative (EITI), particularly at a time when an expansion of aluminum, coal, hydroelectric power, natural gas, gold, titanium, and oil production is on the cards.[2] While Mozambique is on track to meet the MDGs on income poverty, infant and maternal mortality, and access to safe drinking water, particularly in urban areas, other areas such as primary school enrollment, gender equality, and HIV/AIDS call for an efficient service delivery and a more flexible approach to the use of additional donor support as long as it does not compromise macroeconomic stability.

Mozambique: Millennium Development Goal	**Will the goal be met?**
Extreme poverty: halve the proportion of people living in extreme poverty between 1990-2015 from 69% to 34.5%	Possible
HIV/AIDS: Halt and reverse the spread of HIV/AIDS by 2015	Unknown
Hunger: Halve the proportion of people who suffer from hunger by 2015	Unknown
Access to safe water: Halve the proportion of people without safe drinking water by 2015 (rural: raise access from 12% to 66%, urban: raise access from 56% to 78%).	Rural: Possible Urban: Possible
Education: Universal completion of primary education by 2015	Unlikely
Gender equality: Eliminate gender disparity in:	
I. primary education by 2005	Yes
II. secondary education by 2005	Unknown
III. all levels of education by 2015	Unknown
Child mortality: reduce under-5 mortality by 2/3 between 1990 and 2015 (from 226/1000 to 75/1000)	Yes
Maternal health: reduce maternal mortality by ¾ between 1990 and 2015 from $980/10^5$ live births in 1995 to $365/10^5$	Yes
Malaria: Have halted by 2015, and begun to reverse, the incidence of malaria	Unlikely
Environment: Integrate the principles of sustainable development into country policies and programs and reduce the loss of environmental resources	Potentially
Source: World Bank	

10. **The PARPA II is expected to reflect additional expenditures financed by the Multilateral Debt Relief Initiative (MDRI) resources**. The authorities' medium-term financial framework (MTFF) included in PARPA II is expected to phase in additional "priority" spending based on the profile of MDRI debt service relief from the Fund, African Development Fund (AfDF), and the International Development Association (IDA) (estimated at around 0.5 percent of GDP per annum until 2015) in agreement with all stakeholders including the World Bank. Progress in strengthening public expenditure management (PEM) systems should ensure a more effective use of the MDRI resources but should be closely monitored particularly at a time of devolving revenue mobilization and spending responsibilities to subnational units (provinces, districts, and municipalities) that generally have weaker PEM systems (MEFP, paragraphs 13).



Sources: Mozambican authorities; and IMF staff projections.

[2] Four international companies have been granted the right to start drilling for oil in the Rovuma basin.

11. **The medium-term macroeconomic framework is designed to help maintain growth at about 7 percent along a gradual disinflation path over the medium term.** On the basis of the current external financing envelope, the domestic primary deficit is projected to decline gradually underpinned by an average increase in revenue of 0.5 percent of GDP per annum supporting a narrowing of the current account deficit, excluding grants over the medium term.[3] However, if a scaling-up of external assistance materializes it will be used to finance additional "priority" spending with due regard to absorptive capacity and debt sustainability. To facilitate such a flexible approach, the government intends to cost programs that will help achieve the MDGs with the help of the donors and include contingent expenditures in the MTFF in a scenario-type approach which then could be executed in the event of higher aid inflows. A flexible exchange rate system is expected to cushion against exogenous shocks and help maintain a comfortable level of international reserves.

B. Macroeconomic Outlook and Policies for 2006

12. **Prospects for 2006 are for continued strong economic growth (7.9 percent), control of inflation, and the maintenance of a sustainable fiscal and external position** (Table 1). Despite a further increase in the oil import bill expected in 2006, the external current account deficit, including grants, is projected to decrease, mainly on account of a scaling-up of foreign grants (Table 4). However, a continuing rise in international oil prices constitutes a downside risk to the macroeconomic outlook, particularly to inflation dynamics and the trade deficit.[4] The program for 2006 has remained largely unchanged taking into account the MDRI-related expenditures already envisaged in the last staff report. The quantitative base money target was unchanged implying a slight tightening of the monetary stance to keep inflation under control. Overall, NIR should remain above five months of non-megaproject imports.

Fiscal policies

13. **The fiscal framework for 2006 includes additional "priority" expenditure identified in the budget financed by MDRI resources from the Fund** (MEFP, paragraph 11). As such, the domestic primary deficit is higher by about 0.5 percent of GDP than previously envisaged (Table 2).[5] Total domestic revenue is envisaged to rise by about

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[3] The deterioration in the projected current account deficit in 2007 is related to megaproject imports.

[4] A US$10 per barrel rise in oil prices would lead to a 0.8 percent of GDP widening of the trade deficit. To partially accommodate such an exogenous shock, the quarterly NIR floor will be adjusted equivalently downward up to a maximum of US$50 million per annum to the extent that the oil import bill exceeds those projected due to higher global oil prices, as defined in the TMU. The reserves-to-import ratio will still remain at about 4 months of imports under such a scenario.

[5] The implementation of the MDRI by AfDF and IDA is expected to further reduce external debt-related payments by about 0.14 percent of GDP in 2006 assuming delivery of debt relief from July 1, 2006. MDRI debt relief from IDA and AfDF will be fully reflected in the next program review.

0.4 percent of GDP[6] (owing to the collection of tax arrears amounting to about 0.2 percent of GDP, quarterly adjustments to the specific tax rates on fuels that were temporarily halted in the second half of 2005, a broadening of the tax base, continued buoyancy of non-tax revenues related to high commodity prices, and an improvement in tax administration, particularly customs (MEFP, paragraph 12)). The share of spending on priority sectors out of total primary expenditures will exceed 65 percent and increase substantially as a ratio of GDP relative to 2005 financed partly by MDRI resources from the Fund (Table 6).[7] These expenditures will include the hiring of about 10,000 teachers and 2,000 health workers.

14. **The fiscal structural program continues to focus on improving revenue administration and strengthening PEM systems through the rollout of e-SISTAFE.** The operationalization of the ATM by approving the regulations for the ATM law by end-June 2006 (structural benchmark) and implementing its strategic plan along with the establishment of tax tribunals for domestic taxes (structural benchmark for end-June 2006) will help modernize tax administration and procedures (MEFP, paragraph 12). A key priority of the government is to enable effective direct budget execution (according to the sequence of commitment, verification, and payment) for goods and services in the Ministries of Finance, Planning, Education, Agriculture, Health, and Public Works, at the central and provincial levels (a structural performance criterion) by end-July 2006 through the rollout of the Homoine version of software for e-SISTAFE.[8] By end-December 2006, all budgetary operations for goods and services of Financial Management Departments (DAFs) of at least 22 additional ministries and organs (see attached list in the TMU), at the central and provincial levels, will be executed through the e-SISTAFE (structural benchmark) with the support of the donor community. Moreover, off-budget project expenditures will progressively be executed through the Treasury Single Account (TSA) and included in e-SISTAFE, improving the monitoring of all development activities. The allocation of an investment budget for each district will be followed up by developing a plan to gradually rollout e-SISTAFE to all districts by end-September 2006 (structural benchmark).

15. **The public sector reform and governance strategy is at a critical juncture requiring a more action-orientated approach with a high level of commitment and leadership to give a clear sense of direction.** The proposal for Phase II of the public sector

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6 Notwithstanding the decrease of the maximum tariff import rate from 25 percent to 20 percent to all trading partners in the context of the Southern African Development Community (SADC) trade protocol agreement that is estimated to reduce customs revenue by about 0.1 percent of GDP.

7 The Mozambican authorities have decided to place the MDRI resources from the Fund in a special account at the BM to be used by the government to finance "priority" pro-poor spending with all outlays subject to regular budgetary rules and procedures ensuring full transparency and accountability (Table 2).

8 Direct budget execution in these ministries will be implemented as previously envisaged but was delayed by a month due to technical reasons as explained in paragraph 4.

reform program (2006–11) that is being discussed among all stakeholders highlights the need to strengthen the decentralization process (with a focus on building capacity in the districts), and integrate activities and institutions (MEFP, paragraph 30). A timetable of actions will be submitted to the Council of Ministers by end-June 2006. In addition, a decentralization strategy will be developed that, among other things, provides a clear legal, regulatory, and institutional framework for revenue raising and spending responsibilities of subnational units and monitoring of their fiscal operations. To improve payroll management and identify "non-existent" workers, the government is committed to develop a plan to implement an integrated payroll database compatible with e-SISTAFE by end-September 2006. The government is also committed to steadfastly implement the recently approved procurement code and anti-corruption strategy. Overall, public sector reform has an important role to play by improving public service delivery and creating fiscal space to finance higher "priority" expenditures.

Monetary policy and exchange rate policies

16. **The monetary program will continue to target base money (Table 3).** The monetary program is largely unchanged notwithstanding the inflation pressures stemming from exogenous shocks (oil prices and weather) in order to avoid their short-term impact building into inflationary expectations, particularly core (nonfood) inflation (Box 1). The absence of a liquidity overhang in the banking system (Figure 3), and the recent downward trend of nonfood inflation should also help minimize inflationary risks. Bank credit growth to the economy, on the other hand, is programmed to remain robust supported by a rise in government savings and structural factors, albeit decelerating from the pace witnessed in 2005, partly due to the change in the interest rate regime. The complete removal of interest rate caps in the treasury bill and central bank bill (TAM) auctions, completed in March 2006, has led to an increase in the interest rates and a market-determined yield curve, further supporting the monetary-targeting framework. A strengthening of the liquidity forecasting framework, and a deepening of debt markets and debt management, with the help of TA, should help avoid an excessive level of interest rate volatility (MEFP, paragraph 15).

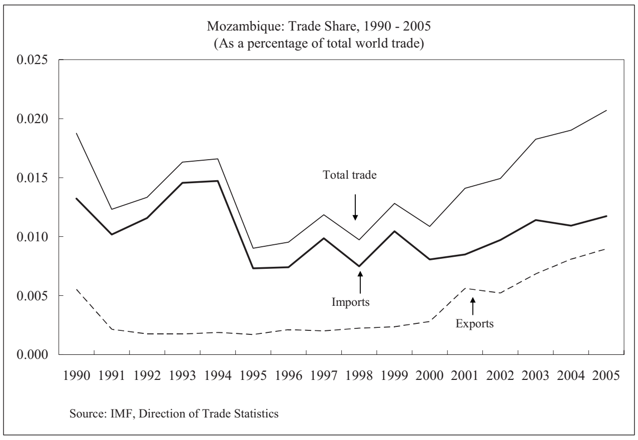
Mozambique: Interest rates in Percent (December 2004–April 2006)

	2004	2005				2006			
	Dec	Mar	Jun	Sep	Dec	Jan	Feb	Mar	Apr 4/
Central bank policy rates									
FPC 1/	13.5	11.2	11.2	11.2	13.8	14.2	15.6	19.0	19.0
FPD 2/	6.3	4.2	4.3	4.2	7.8	8.2	9.6	13.0	13.0
Central bank bills									
Overnight	6.4	4.4	4.4	4.4	7.8	8.1	9.1	12.7	14.0
1 week	6.4	4.4	4.5	4.4	8.1	8.3	9.6	12.3	14.3
Treasury bills									
91 days	10.5	7.5	9.5	9.5	10.2	10.6	11.1	14.9	16.1
182 days	11.0	9.3	10.5	10.5	11.1	11.5	12.0	15.3	16.3
364 days 3/	9.1	9.6	11.0	11.0	11.6	12.0	12.6	15.6	16.8

Source: Central Bank of Mozambique.
1/ Permanent Access Facility.
2/ Standing Deposit Facility (until early October 2005 Excess Liquidity Rate).
3/ Earliest data as of end January 2005.
4/ Data for central bank bills as of April 6, and for treasury bills April 21, 2006.

17. **A "new family" of metical will be introduced on July 1, 2006 (1,000 old meticais will be equal to one new metical).** The BM is coordinating the conversion of bank accounts, and budgetary execution using the new denomination of metical, and has organized a public information campaign (MEFP, paragraph 16).

18. **The impact of large exogenous shocks on a thin foreign exchange market has at times prompted the BM to more tightly "manage" the exchange rate regime (Box 1).** Preliminary analyses show that the REER was roughly in line with macroeconomic fundamentals at end-2005, but that prolonged periods of tight exchange rate management may have led to earlier misalignment,[9] providing a case for greater exchange rate flexibility, albeit with direct interventions to smooth "excessive" volatility in an imperfect market. This calls for a close monitoring of the temporary band in the interbank foreign exchange market, which the authorities have committed to eliminate when conditions permit, although Mozambique's growing share of world trade provides some comfort regarding competitiveness at present.



19. **The sound expansion of the financial system will be supported by a strengthened supervisory framework, and introduction of international accounting standards** (MEFP, paragraphs 17–20). The chart of accounts of the BM and commercial banks will be made consistent with International Financial Reporting Standards (IFRS) by end-September 2006 (structural benchmarks) followed by implementation of best practices in loan classification and provisioning. The supervision of financial institutions will be reinforced by implementing the integral plan for strengthening bank supervising, licensing of microfinance institutions (MFIs), and capacity building of the pension and insurance regulator.

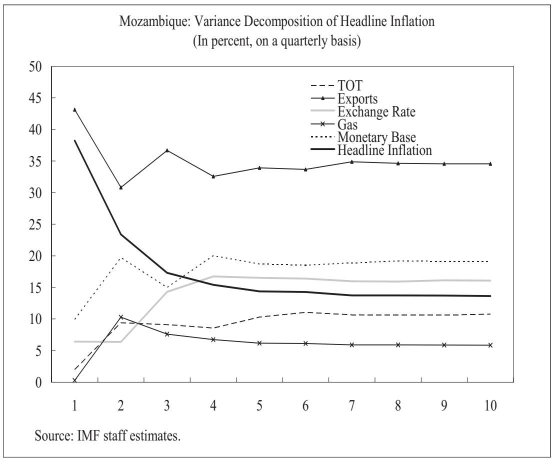
[9] It should be noted, however, that the forecast errors of the statistical techniques used are generally quite large, requiring cautious and careful interpretation.

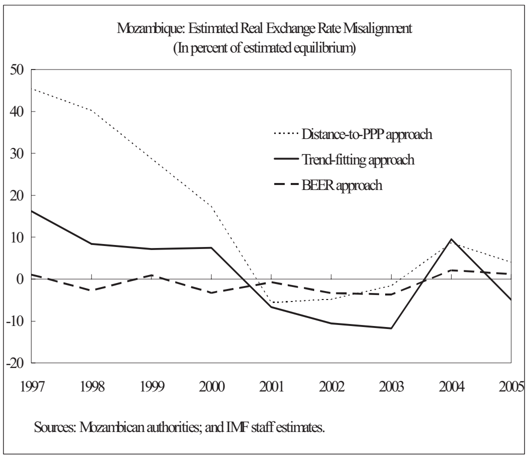
Box 1. Mozambique: Inflation and Real Exchange Rate Dynamics

The BMs major monetary policy challenge is to sterilize liquidity injected as the government draws down (and spends) its external grants and loans in a manner that does not lead to undue movements in inflation and the exchange rate. Preliminary analyses below show that the monetary base seems to be the most appropriate monetary target to control inflation in Mozambique. For a given monetary base target, "excess" liquidity can be mopped up through sales of foreign exchange (compatible with the NIR floor) or net issuance of domestic debt instruments. With a relatively open capital account in a thin foreign exchange market and a monetary anchor, it is important to closely monitor real effective exchange rate (REER) movements to avoid a misalignment or deviation from fundamentals, as it may be costly in terms of loss of competitiveness and a misallocation of resources. Importantly, preliminary analyses below show that the REER seems to be close to its equilibrium at end-2005.

Mozambique was successful in stabilizing inflation after years of hyperinflation in the early 1990s through money-based stabilization programs supported by prudent fiscal policies. Standard vector autoregression analyses show that headline and core (or nonfood) inflation is driven by monetary and exchange rate shocks as well as real export shocks (proxy for supply-side shocks), and a substantial but short-lived inertial component. Interestingly, the pass-through of domestic gas price shocks to core inflation is 0.08 in two quarters (the percent change in price level over an initial percent change in gas prices) but negligible for headline inflation while exchange rate pass-through to headline inflation (at 0.36) is much greater than to core inflation. Monetary aggregates (base money, and to a lesser extent M2 or M3) have an identifiable transmission mechanism to consumer prices while interest rates or NDA do not. Base money control has been elusive at times of difficulties in sterilizing higher net foreign assets (NFA).

The REER seems to have been misaligned at times when the exchange rate regime was more tightly managed for a prolonged period, approaching its equilibrium level at end-2005 following the introduction of the foreign exchange auction system in January 2005. The equilibrium real exchange rate in Mozambique is estimated using three different approaches: (1) the trend-fitting approach; (2) the distance-to-PPP approach; and (3) the Behavioral Equilibrium Exchange Rate (BEER) approach. All three approaches confirm that the REER was likely undervalued between 2001 and 2003 (a period of 'de facto' tight management), became overvalued in 2004 (a period where the BM set the price at which the sales and purchases of foreign currency were transacted), and reverted back towards equilibrium in 2005. On the basis of the BEER approach, we find that the real exchange rate has appreciated in response to relative productivity growth, positive terms of trade (TOT) shocks, and net aid inflows, while it has depreciated in response to increases in NIR or NFA.

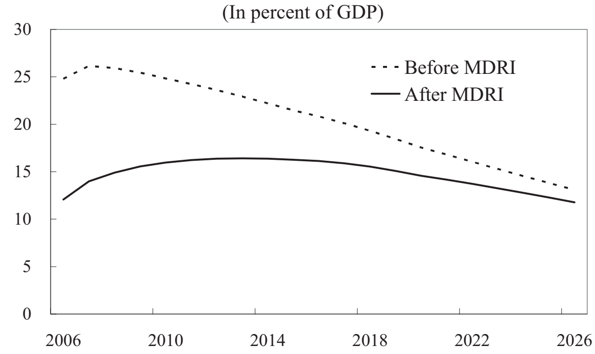




External debt and trade issues

20. **External vulnerability will be reduced as a result of the MDRI, although megaproject-related transactions require vigilance** (Table 8). As a result of the MDRI, the NPV of public external debt is estimated to be approximately halved, from about 25 percent to about 12 percent of GDP in 2006. The joint Bank-Fund DSA (Appendix V) shows that debt dynamics remain sustainable under the baseline and stress tests, albeit susceptible to a ratcheting up of nonconcessional external borrowing. In this respect, the authorities are appropriately committed to seeking non-recourse financing for the transfer of majority ownership of the Cahora Bassa dam operating company, Hidroelétrica de Cahora Bassa (HCB), so not to increase the government's liabilities to commercial creditors.[10] In addition, final agreements have yet to be reached with Paris Club creditors (Japan and Portugal) while negotiations with some large non-Paris Club bilateral creditors (e.g. Algeria, Romania, Libya, and Iraq) in the context of the enhanced HIPC Initiative is proving difficult despite the efforts of the authorities because, according to the authorities, these creditors have not offered comparable treatment.[11] The authorities intend to maintain contact with these creditors, as well as with their commercial creditors, and to continue their good faith negotiations, to facilitate a collaborative agreement with them. The authorities expect the commercial debt buyback operation with private creditors (consistent with comparability of treatment) to be carried out by mid-2006 now that external financing for the operation appears to have been secured. As part of the financing assurances review, the staff finds that adequate safeguards remain in place for further use of Fund resources related to these renegotiations.

Mozambique: NPV of Public External Debt
(In percent of GDP)



Sources: Mozambican authorities; and IMF staff projections.

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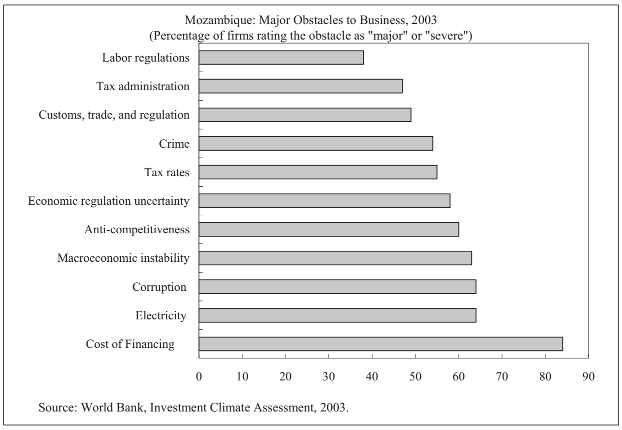
[10] The authorities expect to sign the final agreement with Portugal in the near future and are exploring financing options including from the World Bank Group. The government is firmly committed to ensure (i) the transparency of the process and the final financing package; (ii) that HCB is managed in a commercially efficient manner and will be audited by external auditors; and (iii) that HCB would be subject to the regular concession and tax regimes.

[11] Both Japan and Portugal have expressed their intention to cancel 100 percent of Mozambique's debt owed to them, and are expected to sign these agreements by end-2006.

21. **Exchange and trade system reforms move forward, albeit with some delay.** In January 2006, the maximum import tariff rate applicable to SADC trading partners was lowered from 25 to 20 percent, as planned, and the government submitted a legislative authorization draft to the Assembly to extend this measure to all trading partners. Moreover, the authorities continue to proceed with bilateral free trade arrangements and other measures to improve the business environment (e.g. by reducing the time taken to start a business and global marketing, particularly tourism) in order to promote a diversification of exports, as was recommended in the Action Matrix of the Diagnostic Trade Integration Study (DITS). The authorities have prepared a draft new foreign exchange law that will be submitted to the Assembly by end-September 2006, on the basis of which they intend to accept their obligations under Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement.

Improving the investment climate

22. **The government is discussing an action plan with the World Bank to make Mozambique's investment climate the most competitive among all SADC countries by 2015.** Mozambique is currently ranked 110 (out of 155 countries) in the World Bank's Doing Business 2006 database while the 2003 World Bank Investment Climate Assessment identified the cost of financing, inadequate provision of electricity, and corruption as the top three obstacles to businesses. Some progress has already being made in improving access to finance (both bank credit and outreach of MFIs), and extending the national electricity grid. However, other areas such as increasing labor market flexibility, strengthening contract enforcement and property rights, and bridging the infrastructure gap through greater private participation (and public-private partnerships or PPPs) is vital (MEFP, paragraphs 26-29, 31-32).[12]



Source: World Bank, Investment Climate Assessment, 2003.

23. **A regular and reliable statistical database facilitates effective policy formulation**. The priority should be to compile and disseminate quarterly GDP estimates and a monthly industrial production index, trade and producer price statistics, and report on megaprojects. A recent assessment of Government Financial Statistics (GFS) also saw a need to further extend

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[12] It will be important that any fiscal risks of PPPs are transparently reported in budget documents.

regular fiscal reporting to subnational units and public enterprises, the paucity of which prevents the compilation of general government and consolidated fiscal accounts.

III. Program Monitoring and Risks

24. **The fifth review under the PRGF arrangement is expected to be completed no later than end-December 2006 conditional on meeting the end-June 2006 quantitative performance criteria and other relevant performance criteria through end-September 2006** (MEFP, Tables 1 and 3). The authorities are requesting changes to the performance criteria on the domestic primary deficit and net domestic assets for end-June 2006, to be replaced by ceilings on net credit to the government from the banking system and base money, with further definitions and explanations contained in the annexed MEFP paragraphs 36-38 and TMU, as part of a streamlining of quantitative performance criteria and adjusters under the program to strengthen the macroeconomic management of donor assistance. Changes were also made to streamline the indicative targets.

25. **The main risks to the program include a continuing rise in global oil prices, a weaker-than-programmed revenue performance, and a hasty fiscal decentralization,** which could jeopardize Mozambique's attainment of its macroeconomic objectives.

26. **The BM is continuing to address the remaining weaknesses identified in the Fund's safeguards assessment conducted in June 2004 as planned** (MEFP, paragraph 21).

IV. Staff Appraisal

27. **Macroeconomic performance remains strong despite exogenous shocks.** Real GDP growth is expected to have picked up but agricultural production and the livelihoods of certain groups remain vulnerable to bad weather warranting targeted actions. Despite the spike in domestic petroleum prices, the annual average inflation rate decelerated in 2005, albeit rising in the last few months. Higher cereal imports and the oil price shock widened the trade deficit contributing to depreciation pressures, particularly the financing of lumpy oil import payments and consequent portfolio shifts in a thin market. The outlook for 2006 is a continuation of strong growth, a containment of inflationary pressures, and the maintenance of a comfortable external position, albeit with some risks related to exogenous shocks.

28. **Overall program performance in 2005 was satisfactory**. All quantitative performance criteria were met while the structural program experienced slight delays related to the approval of the anti-corruption strategy and decision on the restructuring option for the state-owned petroleum distributor.

29. **The strategy to consolidate macroeconomic stability and launch a "second wave of reforms" in PARPA II should help sustain broad-based growth and poverty**

reduction. This will require a two-pronged strategy of persevering with the stabilization effort, and buttressing the investment climate by reducing the cost of doing business and good governance. The staff also welcomes the willingness to strengthen the transparency of natural resource management and megaprojects by adhering to the core principles—transparency and accountability—of the EITI. Without these institutional reforms, growth could suffer. To help achieve the MDGs, the government should ensure that additional external financing including MDRI resources is allocated to the most economically (infrastructure) and socially productive (education, health, HIV/AIDS) areas, facilitated by a flexible program design that supports higher "priority" spending in a manner that does not compromise macroeconomic stability.

30. **The public sector reform and governance strategy is at a critical juncture requiring a more action-orientated approach with a high level of commitment and leadership.** The commitments to continued domestic revenue mobilization efforts, PEM reforms, and reinvigorating the public sector reform program and governance strategy are key to improving public service delivery.

31. **The 2006 fiscal framework is consistent with the PARPA II objectives**. A continued rise in domestic revenue is envisaged taking into account revenue losses related to trade liberalization while the share of "priority" expenditures will exceed the PARPA target financed partly by MDRI resources from the Fund. The rollout of e-SISTAFE to key PARPA ministries by end-July and most public entities at the central and provincial level by end-2006 should ensure a better monitoring of expenditures. Moreover, off-budget donor-funded projects should progressively be brought on budget and included in e-SISTAFE with the help of the donors.

32. **The governments' decentralization strategy should be clarified in a policy document followed by appropriate checks and balances**. There are some ambiguities concerning the division of revenue raising and spending responsibilities of subnational units, and concerns regarding the capacity of some districts and municipalities to effectively absorb and account for resources. The execution of the investment budget allocated to each district should be closely monitored and adhere to the new procurement code once operational.

33. **The BM should continue to target base-money, in conjunction with a flexible exchange rate regime**. This approach has served the country well when executed steadily, ensuring that the domestic liquidity impact of aid inflows is sterilized, that inflation is kept under control, and that competitiveness is not compromised. The staff commend the removal of the interest rate caps in the treasury bill auctions that make the monetary framework more consistent while a strengthening of liquidity management and deepening of debt markets should help avoid an excessive level of interest rate volatility. In addition, the staff welcomes the authorities' commitment to a flexible exchange rate system, which has served

Mozambique well helping cushion exogenous shocks, and to eliminate the temporary exchange rate band when the conditions permit.

34. **The preparations for the introduction of the new metical have been comprehensive,** and should not result in higher inflation as long as the exchange of old notes and coins to new ones is well handled as planned. A continued public information campaign covering the entire country is important to avoid a black market emerging for exchanging old to new metical as unscrupulous individuals may attempt to take advantage of the poorest segments of the population.

35. **Mozambique's banking system is starting to make a growing contribution to private sector development**. Strengthened supervision and the introduction of IFRS should ensure financial stability but the BM should closely monitor the recent acceleration of bank credit and strictly enforce all prudential regulations, including to the growing MFI sector.

36. **The joint DSA shows that Mozambique's external debt levels will remain well below its indicative thresholds for debt distress in the foreseeable future.** However, a ratcheting up of nonconcessional external borrowing will make the debt situation more vulnerable. As such, the authorities' renewed commitment to seek financing for the transfer of majority ownership of HCB through non-recourse financing that does not increase the government's liabilities to commercial creditors is prudent. The authorities should continue to negotiate in good faith with all of its external creditors to facilitate a collaborative agreement consistent with comparability of treatment.

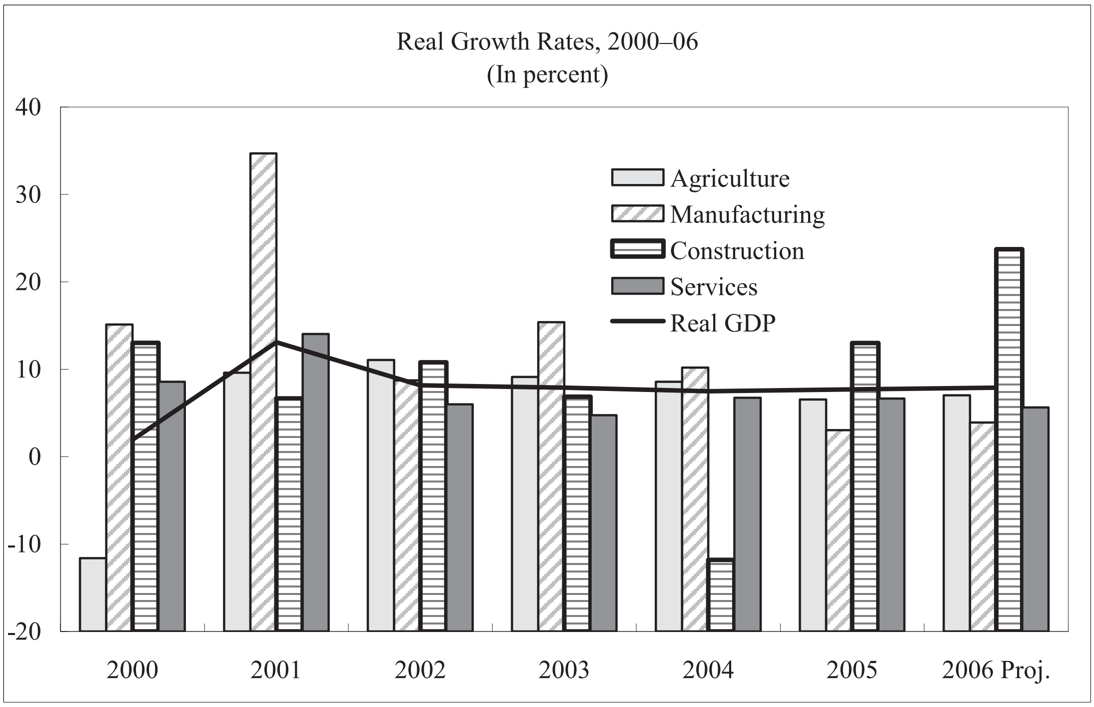
37. **The staff welcomes progress in liberalizing trade and exchange system reforms.** The staff looks forward to the lowering of the maximum tariff level to all trading partners and submission of the draft new foreign exchange law to the Assembly by mid-2006 with the intention of accepting obligations under Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement.

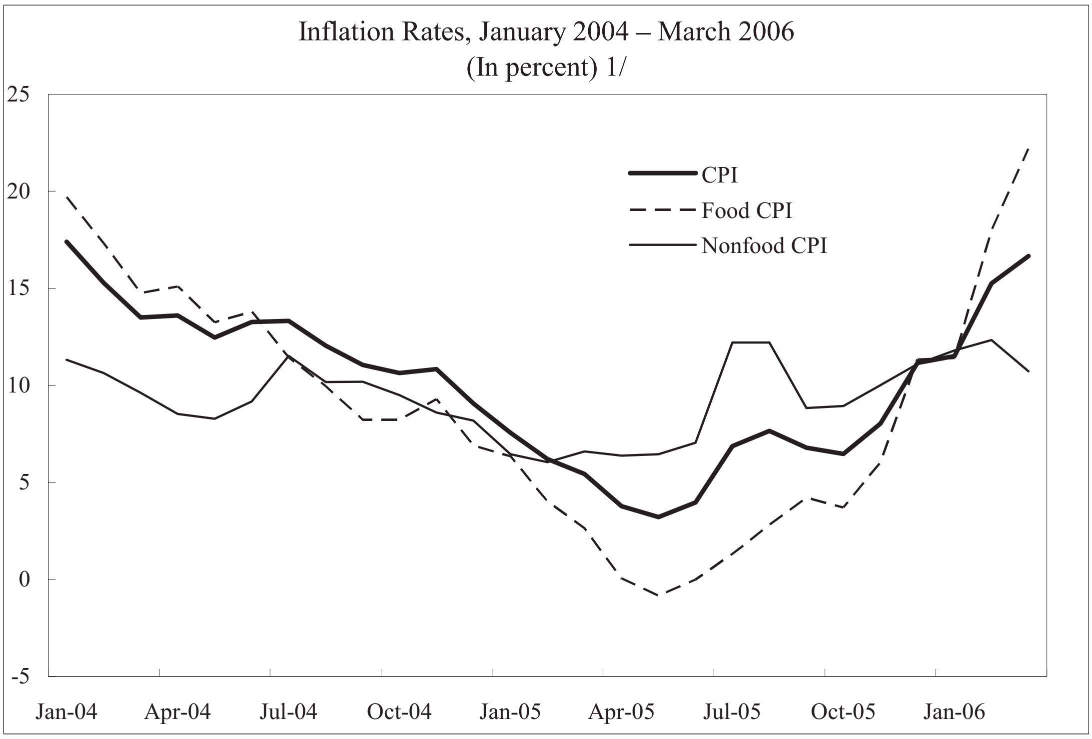
38. **On the risks to the program, the staff notes that a weaker-than-programmed revenue performance, a continuing rise in global oil prices, and a hasty implementation of fiscal decentralization,** could jeopardize the government's fiscal and poverty reduction targets.

39. **The staff recommends completion of the fourth review and financing assurances review under the PRGF arrangement and supports the modification of the NIR and NDA performance criteria for end-June 2006 as part of a streamlining of quantitative targets**.

40. **The staff welcomes the intention of the authorities to make public the staff report, the letter of intent, and the MEFP**.

Figure 1. Mozambique: Real Growth Rates and Inflation

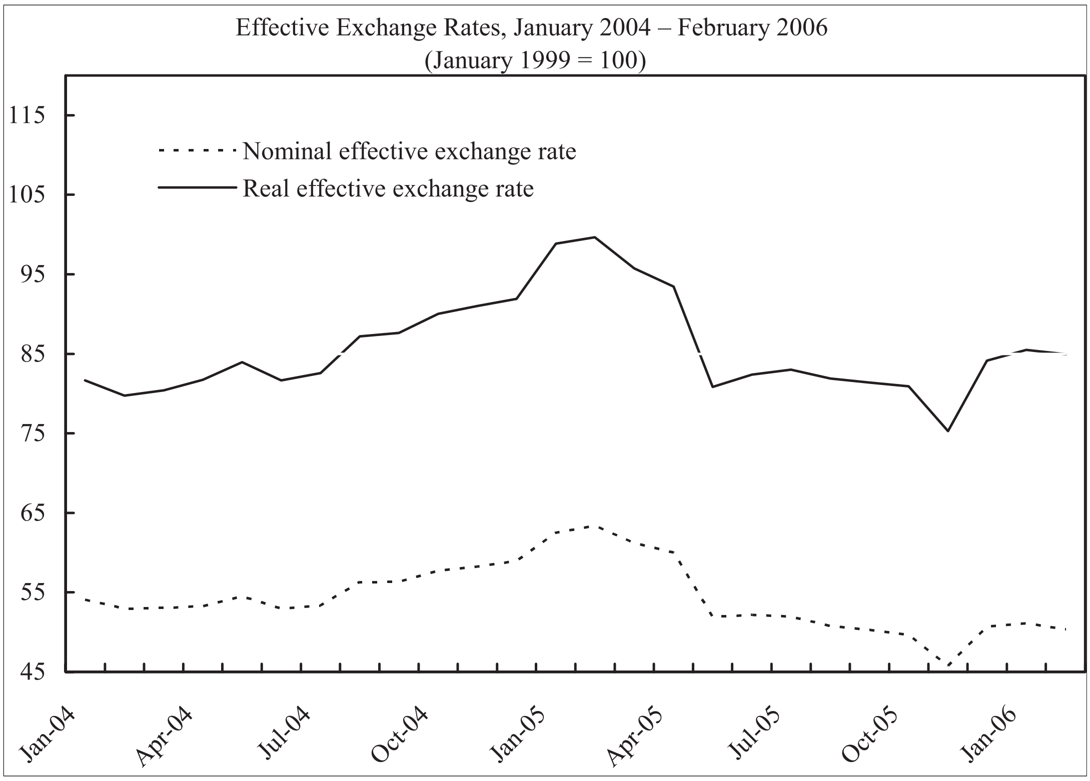


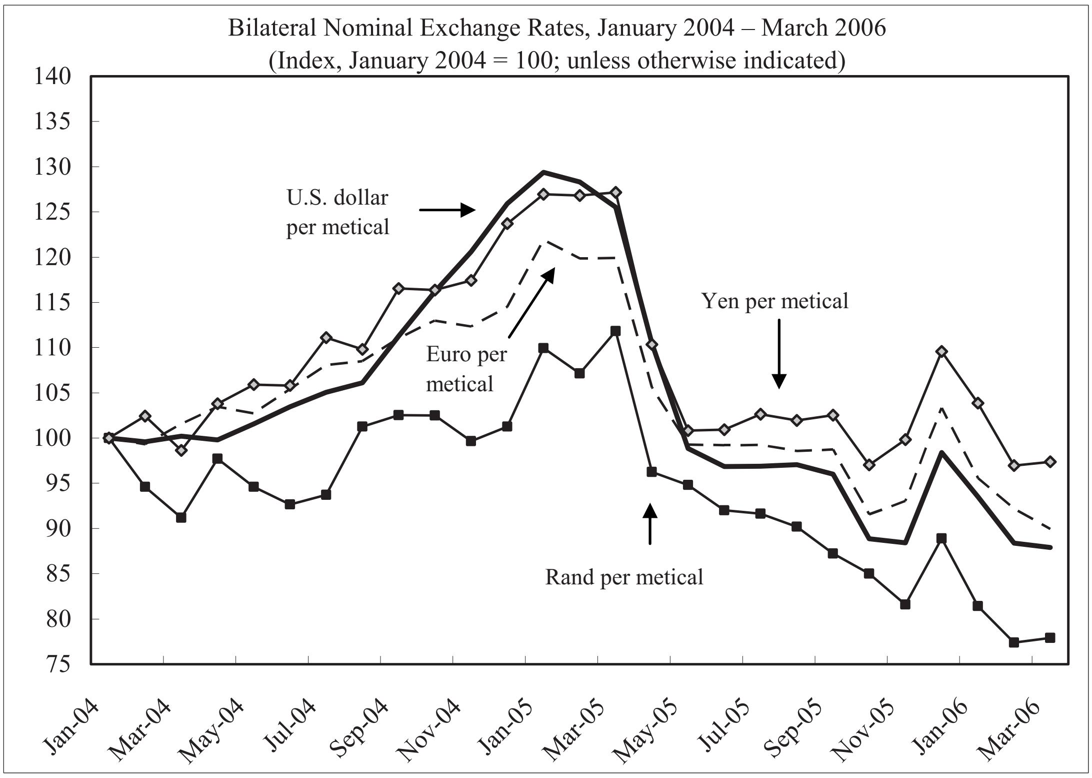


Sources: Mozambican authorities; and IMF staff estimates and projections.

1/ Twelve-month rate of change.

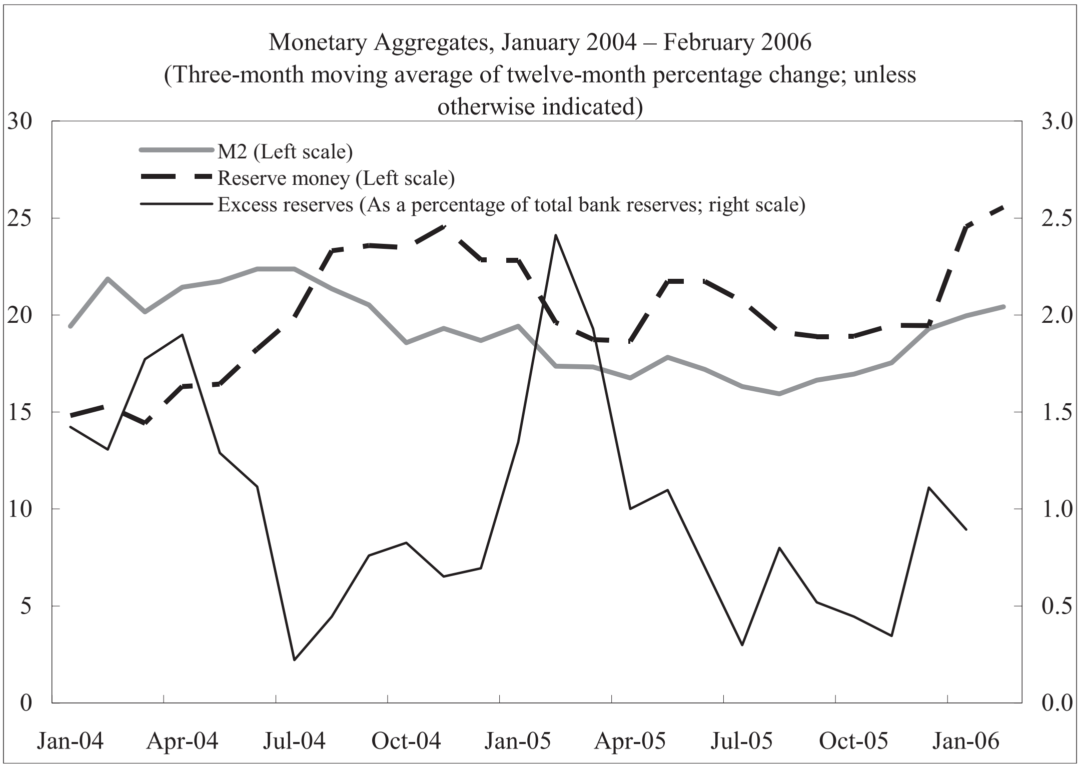
Figure 2. Mozambique: Exchange Rates

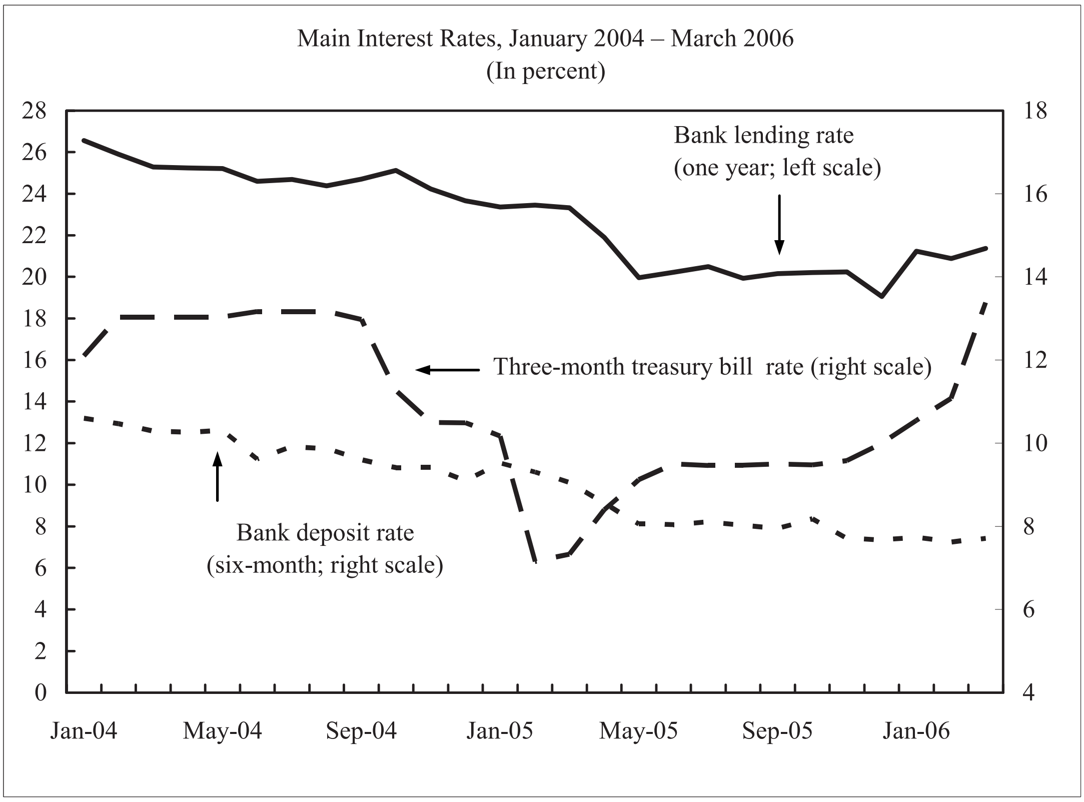




Sources: Mozambican authorities; and IMF staff estimates; and IMF, Information Notice System.

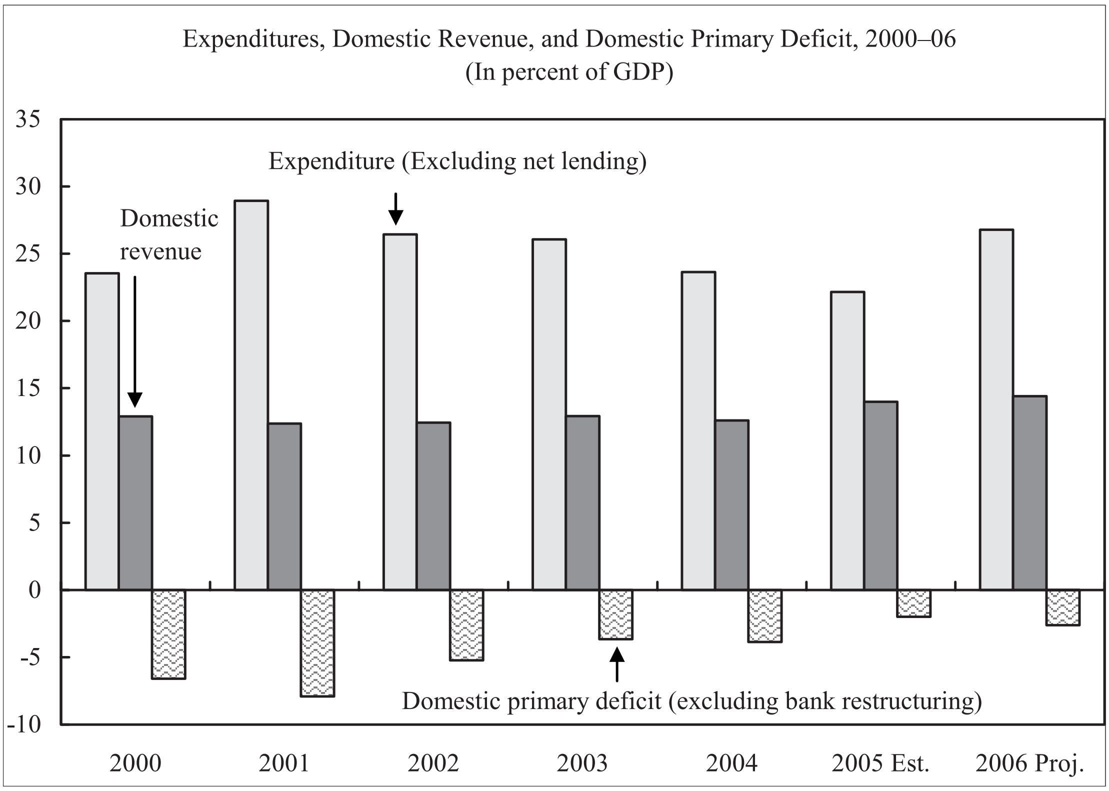
Figure 3. Monetary Aggregates and Interest Rates

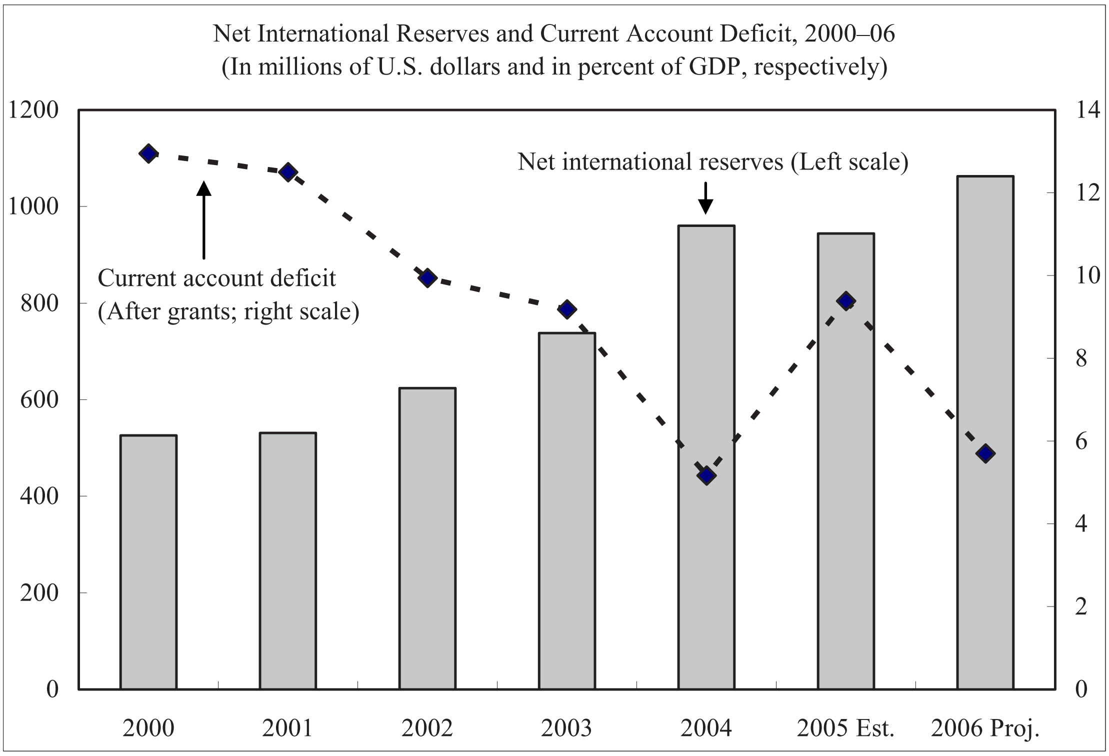




Sources: Mozambican authorities; and IMF staff estimates.

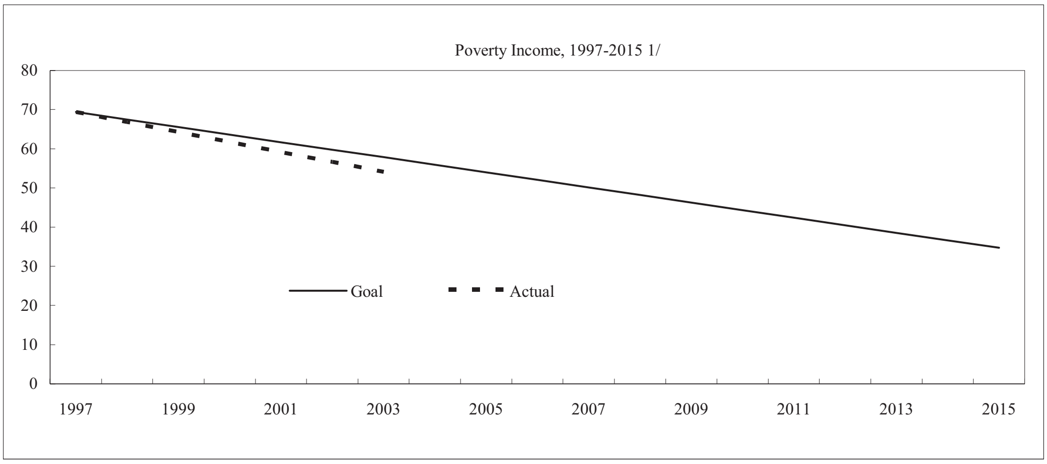
Figure 4. Mozambique: Fiscal and External Sector Indicators

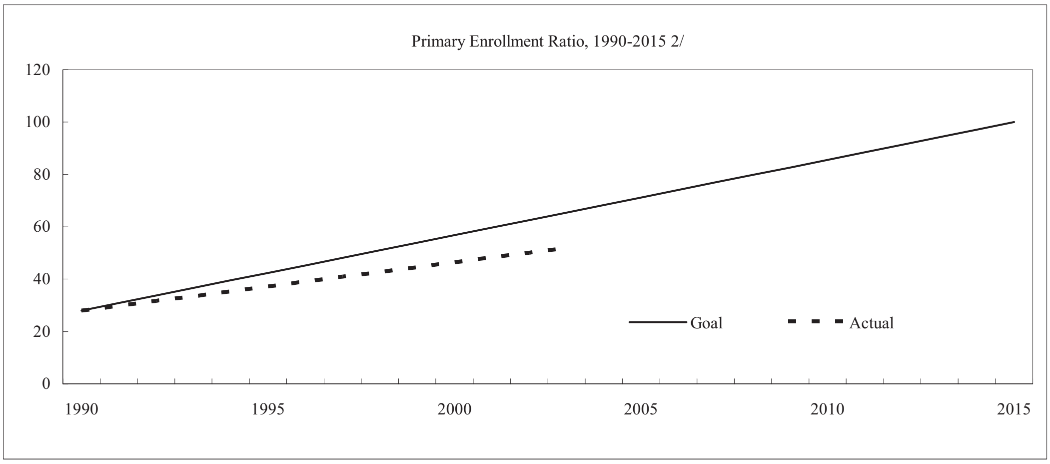


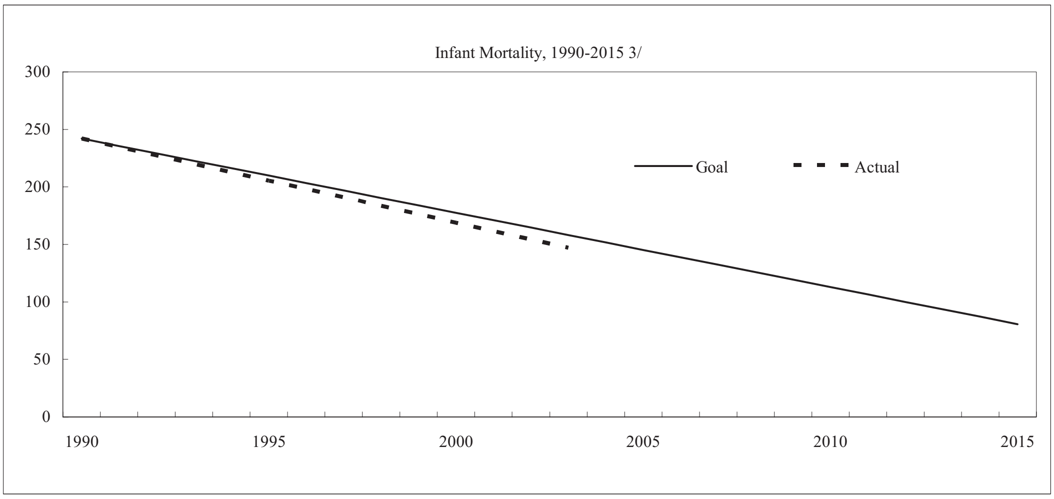


Sources: Mozambican authorities; and IMF staff estimates and projections.

Figure 5. Mozambique: Progress in Meeting the Millenium Development Goals







Sources: The World Bank; and Instituto Nacional de Estatistica, Household Surveys, 1996/97 and 2002/03.

1/ A household consumption survey was conducted between 1996 and 1997, and 2002 and 2003, to determine poverty incidence. The methodology includes determining a sum of food and nonfood poverty lines. Households are defined as poor if their daily per capita expenditure is less than the total poverty line.
2/ Measured in net terms and as a percentage of relevant age group.
3/ Under-five infant mortality rate (per 1,000).

Table 1. Mozambique: Selected Economic and Financial Indicators, 2004–09

	2004	2005		2006		2007	2008	2009
	Est.	Prog.	Est.	Prog.	Rev. Prog.	Proj.	Proj.	Proj.
	(Annual percentage change, unless otherwise indicated)							
National income and prices								
Nominal GDP (in billions of meticais)	133,510	152,894	153,041	177,268	180,831	208,970	236,408	266,732
Nominal GDP growth	17.2	14.5	14.0	15.9	17.6	15.7	13.1	13.0
Real GDP growth	7.5	7.7	7.7	7.9	7.9	7.0	7.0	7.0
GDP per capita (in U.S. dollars)	309	345	339	345	346	357	384	415
Consumer price index (annual average)	12.6	6.3	6.4	7.5	9.5	8.0	5.7	5.4
Consumer price index (end of period)	9.1	8.0	11.2	7.0	7.0	6.0	5.5	5.4
External sector								
Merchandise exports	44.1	14.8	16.1	4.2	20.4	6.9	-0.9	6.2
Merchandise exports, excluding megaprojects	25.4	3.0	6.0	8.7	10.2	7.2	9.0	12.8
Merchandise imports	16.9	17.3	21.2	5.4	10.5	6.8	4.7	6.4
Merchandise imports, excluding megaprojects	22.0	14.7	19.3	6.6	9.9	4.7	7.9	8.0
Terms of trade	12.7	5.8	9.4	-4.1	4.7	-9.8	-8.7	-8.7
Nominal effective exchange rate (end of period) 1/	10.7	...	-14.0	...	...	...	...	...
Real effective exchange rate (end of period) 1/	17.5	...	-8.5	...	...	...	...	...
	(Annual changes in percent of beginning-of-period stock of money, unless otherwise indicated)							
Money and credit								
Net foreign assets	37.5	22.0	22.9	5.6	20.4	8.2	2.8	4.9
Net domestic assets 2/	-31.5	6.3	4.2	10.4	-7.2	5.6	8.4	6.4
Of which : net credit to the government 3/	-9.7	6.7	-1.0	-0.8	-6.9	2.4	-1.7	-3.2
net credit to the economy	-2.5	11.7	22.5	11.3	17.1	13.0	12.2	11.4
M2 (12-month percent change)	16.7	16.4	22.1	15.2	18.5	17.5	15.5	14.5
Velocity (GDP/M2)	5.9	5.8	5.5	6.1	5.5	5.4	5.3	5.2
Interest rate for 90-day treasury bills/TAMs (in percent; end of period) 4/	10.5	...	10.2	...	14.5	...	...	...
	(In percent of GDP)							
Investment and saving								
Gross domestic investment	22.6	22.2	20.4	23.8	24.9	25.1	25.6	26.1
Government	9.4	11.7	8.4	11.8	11.9	12.2	12.0	12.0
Other sectors	13.2	10.5	12.0	11.9	12.9	12.9	13.5	14.1
Gross domestic savings (excluding grants)	8.5	5.2	4.4	6.3	7.7	7.4	9.2	11.8
Government	-1.6	-0.7	0.2	-0.1	-0.4	-0.1	0.8	1.8
Other sectors	10.1	5.9	4.2	6.4	8.2	7.4	8.4	10.0
Current account, before grants	-14.1	-17.0	-15.9	-17.4	-17.1	-17.8	-16.4	-14.4
Government budget								
Total revenue	12.6	13.8	14.0	14.5	14.4	14.9	15.4	16.0
Total expenditure and net lending (including residual)	24.4	27.1	22.6	27.5	27.8	28.3	27.5	26.9
Overall balance, before grants	-12.0	-13.3	-8.9	-13.0	-13.4	-13.4	-12.1	-10.9
Total grants	7.5	7.7	6.5	9.1	11.1	8.8	8.2	7.6
Overall balance, after grants	-4.5	-5.6	-2.3	-3.9	-2.4	-4.6	-3.9	-3.3
Domestic primary balance	-3.9	-2.9	-2.0	-2.1	-2.6	-2.4	-2.2	-2.2
External financing (including debt relief) 5/	3.2	5.4	3.5	5.1	4.8	5.0	4.4	3.7
Net domestic financing	-0.5	0.2	-1.5	-1.3	-2.5	-0.4	-0.5	-0.5
Privatization 5/	1.9	0.0	0.3	0.1	0.1	0.1	0.0	0.0
	(In percent of exports of goods and nonfactor services)							
External debt service (nonfinancial public sector)								
Scheduled, after additional bilateral assistance and MDRI	3.4	5.1	7.0	5.3	2.0	2.2	2.2	2.3
	(In millions of U.S. dollars, unless otherwise indicated)							
Overall balance of payments	213	-83	-55	-8	-31	122	41	83
Net international reserves (end of period)	960	900	944	923	1,063	1,182	1,223	1,307
Gross international reserves (end of period)	1,160	1,076	1,105	1,068	1,074	1,195	1,237	1,320
In months of imports of goods and nonfactor services	5.8	4.6	4.6	4.4	4.1	4.2	4.2	4.2
In months of imports of goods and nonfactor services, excluding megaprojects	7.0	5.6	5.8	5.2	5.1	5.3	5.1	5.0
Exchange rate (meticais per U.S. dollar; end of period)	18,899	...	24,183	...	...	...	…	…

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

Note: Takes into account IMF delivery of MDRI in January 2006.

1/ A minus sign indicates depreciation.
2/ The percentage change for net domestic assets in the estimate for 2004 was adjusted to take account of the shifting of the external liabilities of the Bank of Mozambique (BM) to the government.
3/ Includes the issuance of government securities for the central bank recapitalization in years 2005–07.
4/ TAMs stands for *titulos das autoridades monetarias* . TAMs are debt instruments issued by the Bank of Mozambique. Data for 2006 is at March 24.
5/ Includes movement in the government account set abroad with the proceeds of the Moatize coal mine concession.

Table 2. Mozambique: Government Finances, 2004–09

	2004 1/	2005		2006		2007	2008	2009
	Est.	Prog.	Est.	Prog	Rev. Prog.	Proj.	Proj.	Proj.
				(In billions of meticais)				
Total revenue	16,838	21,089	21,418	25,685	26,052	31,089	36,332	42,573
Tax revenue	15,598	18,923	18,534	22,762	23,043	27,672	31,757	36,555
Taxes on income and profits	3,548	4,445	4,469	5,487	5,488	6,953	8,200	9,552
Taxes on goods and services	9,416	10,845	10,873	13,015	13,283	15,813	18,116	20,956
Of which : on petroleum products	1,663	2,089	1,806	2,631	2,321	2,778	3,216	3,695
Taxes on international trade	2,284	3,075	2,816	3,552	3,680	4,211	4,651	5,149
Other taxes	350	558	376	708	591	694	791	898
Nontax revenue plus additional revenue effort 2007–09	1,241	2,167	2,884	2,773	3,010	3,418	4,575	6,017
Total expenditure and net lending	32,607	41,408	34,582	48,697	50,355	59,140	65,039	71,665
Current expenditure	19,006	22,099	21,092	25,788	26,832	31,232	34,502	37,890
Compensation to employees	9,195	11,045	10,691	13,148	13,345	15,747	17,815	20,100
Goods and services	4,727	5,520	5,012	6,031	6,907	7,639	8,641	9,748
Interest on public debt	1,321	1,309	1,248	1,567	1,576	2,416	2,483	2,354
Domestic	910	921	789	1,080	1,081	1,875	1,906	1,733
External	411	388	459	487	496	541	577	621
Transfer payments	3,763	4,225	4,141	5,041	5,003	5,430	5,564	5,689
Domestic current primary balance	-847	299	1,574	1,465	797	2,274	4,313	7,036
Capital expenditure	12,543	17,942	12,819	20,990	21,592	25,474	28,461	31,907
Grant finance projects	3,085	4,528	1,918	4,916	5,030	5,424	5,569	5,691
Projet loans	3,564	5,373	3,148	4,712	4,783	5,478	5,624	5,747
Locally financed	4,074	4,797	4,335	5,357	5,670	7,445	9,692	13,107
Grant-financed special programs	1,197	2,212	2,151	4,686	4,764	5,451	5,737	5,862
Direct financing	623	489	717	907	928	999	1,026	1,049
Expenditure financed with fund for the concession mine of Tete	...	544	550	411	417	677	813	450
Net lending	1,058	1,367	671	1,920	1,931	2,434	2,076	1,868
Of which : locally financed	-79	-16	-94	-138	-137	-161	-189	-219
Domestic primary balance, before grants, above the line 2/	-4,842	-4,481	-2,667	-3,754	-4,736	-5,010	-5,190	-5,852
Unallocated revenue (+)/expenditure (-) 3/	-310	0	-384	0	0	0	0	0
Overall balance, before grants (below the line)	-16,079	-20,319	-13,549	-23,012	-24,303	-28,050	-28,707	-29,093
Grants received	10,053	11,791	9,975	16,155	19,992	18,462	19,431	20,218
Project	6,185	7,229	4,938	10,509	10,722	11,875	12,332	12,602
Nonproject	3,868	4,562	5,037	5,645	5,655	6,587	7,099	7,615
IMF MDRI assistance via the central bank 4/		0	0	0	3,615	0	0	0
Overall balance, after grants	-6,026	-8,528	-3,574	-6,857	-4,310	-9,589	-9,276	-8,875
Central bank transfer of HIPC Initiative assistance by the IMF	484	366	368	428	0	0	0	0
Net external financing	3,788	7,931	5,035	8,587	8,725	10,356	10,380	9,999
Disbursements	6,937	8,297	5,219	9,108	9,256	10,643	10,528	10,527
Project	3,564	5,373	3,148	4,712	4,783	5,478	5,624	5,747
Nonproject	3,373	2,925	2,071	4,395	4,473	5,165	4,904	4,780
Cash amortization	-668	-909	-734	-932	-948	-964	-961	-978
Investment abroad 5/	-2,481	544	550	411	417	677	813	450
Net domestic financing	-728	231	-2,223	-2,259	-4,518	-872	-1,208	-1,229
Of which : IMF MDRI					-3,615			
Privatization 6/	2482	0	394	102	104	104	104	104
Memorandum items:								
Domestic primary balance, before grants, below the line 2/	-5,152	-4,481	-3,052	-3,754	-4,736	-5,010	-5,190	-5,852
Balance on MDRI deposit account with the central bank	0	0	0	0	2,687	1,792	897	0
Grants and loan disbursements	16,990	20,088	15,194	25,262	29,248	29,105	29,959	30,745
Nominal GDP	133,510	152,894	153,041	177,268	180,831	208,970	236,408	266,732

Table 2. Mozambique: Government Finances, 2004–09 (Concluded)

	2004 1/	2005		2006		2007	2008	2009
	Est.	Prog.	Est.	Prog.	Rev. Prog.	Proj.	Proj.	Proj.
	(In percent of GDP, unless otherwise specified)							
Total revenue	12.6	13.8	14.0	14.5	14.4	14.9	15.4	16.0
Tax revenue	11.7	12.4	12.1	12.8	12.7	13.2	13.4	13.7
Taxes on income and profits	2.7	2.9	2.9	3.1	3.0	3.3	3.5	3.6
Taxes on goods and services	7.1	7.1	7.1	7.3	7.3	7.6	7.7	7.9
Of which : on petroleum products	1.2	1.4	1.2	1.5	1.3	1.3	1.4	1.4
Taxes on international trade	1.7	2.0	1.8	2.0	2.0	2.0	2.0	1.9
Other taxes	0.3	0.4	0.2	0.4	0.3	0.3	0.3	0.3
Nontax revenue plus additional revenue effort 2007–09	0.9	1.4	1.9	1.6	1.7	1.6	1.9	2.3
Total expenditure and net lending	24.4	27.1	22.6	27.5	27.8	28.3	27.5	26.9
Current expenditure	14.2	14.5	13.8	14.5	14.8	14.9	14.6	14.2
Compensation to employees	6.9	7.2	7.0	7.4	7.4	7.5	7.5	7.5
Goods and services	3.5	3.6	3.3	3.4	3.8	3.7	3.7	3.7
Interest on public debt	1.0	0.9	0.8	0.9	0.9	1.2	1.1	0.9
Domestic	0.7	0.6	0.5	0.6	0.6	0.9	0.8	0.6
External	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.2
Transfer payments	2.8	2.8	2.7	2.8	2.8	2.6	2.4	2.1
Domestic current primary balance	-0.6	0.2	1.1	0.8	0.4	1.1	1.8	2.6
Capital expenditure	9.4	11.7	8.4	11.8	11.9	12.2	12.0	12.0
Of which : locally financed	3.1	3.1	2.8	3.0	3.1	3.6	4.1	4.9
Net lending	0.8	0.9	0.4	1.1	1.1	1.2	0.9	0.7
Of which : locally financed	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Domestic primary balance, above the line 2/	-3.6	-2.9	-1.7	-2.1	-2.6	-2.4	-2.2	-2.2
Unallocated revenue (+)/expenditure (-) 3/	-0.2	0.0	-0.3	0.0	0.0	0.0	0.0	0.0
Overall balance, before grants (below the line)	-12.0	-13.3	-8.9	-13.0	-13.4	-13.4	-12.1	-10.9
Grants received	7.5	7.7	6.5	9.1	11.1	8.8	8.2	7.6
Project	4.6	4.7	3.2	5.9	5.9	5.7	5.2	4.7
Nonproject	2.9	3.0	3.3	3.2	3.1	3.2	3.0	2.9
IMF MDRI assistance via the central bank 4/	0.0	0.0	0.0	0.0	2.0	0.0	0.0	0.0
Overall balance, after grants	-4.5	-5.6	-2.3	-3.9	-2.4	-4.6	-3.9	-3.3
Central bank transfer of HIPC assistance by the IMF	0.4	0.2	0.2	0.2	0.0	0.0	0.0	0.0
Net external financing	2.8	5.2	3.3	4.8	4.8	5.0	4.4	3.7
Disbursements	5.2	5.4	3.4	5.1	5.1	5.1	4.5	3.9
Project	2.7	3.5	2.1	2.7	2.6	2.6	2.4	2.2
Nonproject	2.5	1.9	1.4	2.5	2.5	2.5	2.1	1.8
Cash amortization	-0.5	-0.6	-0.5	-0.5	-0.5	-0.5	-0.4	-0.4
Investment abroad 5/	-1.9	0.4	0.4	0.2	0.2	0.3	0.3	0.2
Net domestic financing	-0.5	0.2	-1.5	-1.3	-2.5	-0.4	-0.5	-0.5
Privatization 6/	1.9	0.0	0.3	0.1	0.1	0.1	0.0	0.0
Memorandum items:								
Domestic primary balance, before grants, below the line 2/	-3.9	-2.9	-2.0	-2.1	-2.6	-2.4	-2.2	-2.2
Balance on MDRI deposit account with the central bank	0.0	0.0	0.0	0.0	1.5	0.9	0.4	0.0
Grants and loans disbursements	12.7	13.1	9.9	14.3	16.2	13.9	12.7	11.5
Nominal GDP (in billions of meticais)	133,510	152,894	153,041	177,268	180,831	208,970	236,408	266,732

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

1/ The quasi-fiscal deficit of the Bank of Mozambique, amounting to Mt 3,455 billion (or 2.5 percent of GDP) is not included.
2/ Revenue minus noninterest current expenditure minus locally financed capital expenditure and locally financed net lending. Unallocated revenue and expenditure are included in the primary balance.
3/ Residual discrepancy between identified sources and use of funds.
4/ Includes the transfer of both MDRI and HIPC assistance from the central bank to the budget in 2006. MDRI debt relief from IDA and AfDF are currently excluded and will be fully reflected in the next program review.
5/ Tracks the movements in the government account set up abroad with the proceeds of the Moatize coal mine concession.
6/ Includes in 2004 the US$123 million (2.0 percent of GDP) concession fee for the Moatize coal mine concession.

Table 3. Mozambique: Monetary Survey, 2004–09

	2004	2005		2006		2007	2008	2009
	Rev. Actual	Prog.	Est.	Prog	Rev. Prog.	Proj.	Proj.	Proj.
	(In billions of meticais, unless otherwise specified)							
Central bank								
Net foreign assets	21,504	25,423	26,047	26,701	33,485	37,241	38,547	41,337
(in millions of U.S. dollars)	1,138	998	1,082	1,004	1,184	1,279	1,293	1,355
Net international reserves	18,152	22,929	22,734	24,547	30,057	34,402	36,465	39,664
(in millions of U.S. dollars)	960	900	944	923	1,063	1,182	1,223	1,300
Medium- and long-term foreign liabilities	-57	-76	-64	-80	-85	-87	-89	-92
(in millions of U.S. dollars)	-3	-3	-3	-3	-3	-3	-3	-3
Other	3,409	2,571	3,376	2,234	3,514	2,926	2,171	1,764
(in millions of U.S. dollars)	180	101	140	84	124	101	73	58
Net domestic assets	-11,071	-13,218	-13,894	-12,663	-19,498	-21,221	-20,333	-20,759
Credit to government (net)	-11,245	-13,493	-14,762	-12,582	-13,713	-12,017	-10,217	-9,737
Credit to banks (net)	-3,859	0	408	24	24	120	116	129
Credit to the economy	1	1	1	1	1	1	1	1
Other items (net; assets +)	4,033	274	459	490	-5,810	-9,324	-10,233	-11,153
Reserve money	10,433	12,205	12,153	14,038	13,988	16,020	18,214	20,578
Currency outside banks	5,225	5,983	6,110	6,937	6,784	8,811	10,109	11,318
Bank reserves	5,209	6,222	6,042	7,101	7,204	7,209	8,105	9,260
Currency in banks	978	822	1,226	836	1,694	1,169	1,521	2,019
Deposits	4,231	5,400	4,817	6,265	5,509	6,040	6,585	7,241
Deposit money banks								
Net foreign assets	4,994	7,388	8,270	8,510	9,702	9,985	10,227	10,465
(in millions of U.S. dollars)	264	290	343	320	343	343	343	343
Net domestic assets	23,955	29,347	29,061	34,106	32,678	37,167	41,898	47,434
Banks' reserves	5,209	6,222	6,042	7,101	7,204	7,209	8,105	9,260
Central bank liabilities with commercial banks (net)	4,009	0	-535	-24	-24	-120	-116	-129
Credit to government (net)	4,561	9,178	7,748	7,920	3,712	3,174	407	-2,058
Credit to the economy	13,512	17,515	21,215	22,353	28,640	35,039	41,880	48,978
Other items (net; assets +)	-3,336	-3,568	-5,408	-3,243	-6,853	-8,136	-8,378	-8,617
Deposits	28,950	36,735	37,331	42,616	42,380	47,151	52,125	57,899
Demand and savings deposits	19,255	23,878	26,177	27,701	21,190	30,648	33,881	37,635
Time deposits	9,695	12,857	11,154	14,916	21,190	16,503	18,244	20,265
Monetary survey								
Net foreign assets	26,499	32,811	34,316	35,211	43,187	47,225	48,774	51,802
Net domestic assets	7,675	9,907	9,125	14,341	5,976	8,737	13,460	17,415
Domestic credit	6,828	13,201	14,201	17,691	18,640	26,198	32,071	37,184
Credit to government (net)	-6,684	-4,315	-7,014	-4,663	-10,001	-8,843	-9,810	-11,795
Credit to the economy	13,513	17,516	21,215	22,354	28,640	35,040	41,881	48,979
Of which : in foreign currency	7,892	9,950	10,656	12,474	11,456	15,768	16,752	19,592
Of which : in domestic currency	5,621	7,566	10,559	9,880	17,184	19,272	25,129	29,387
Other items (net; assets +)	847	-3,294	-5,077	-3,350	-12,663	-17,461	-18,612	-19,770
Money and quasi money (M3)	34,174	42,718	43,441	49,553	49,164	55,962	62,234	69,217
Foreign currency deposits	11,522	16,340	15,793	19,177	16,401	17,466	17,770	18,307
(in millions of U.S. dollars)	610	641	656	721	580	800	596	800
M2	22,653	26,356	27,648	30,376	32,763	38,496	44,463	50,910
Currency outside banks	5,225	5,983	6,110	6,937	6,784	8,811	10,109	11,318
Domestic currency deposits	17,428	20,373	21,538	23,439	25,979	29,685	34,354	39,593
Memorandum items:								
MDRI assistance via the central bank 1/	0	0	0	0	3,615	0	0	0
(in millions of U.S. dollars)	0	0	0	0	154	0	0	0
Balance on MDRI deposit account with the central bank 2/	0	0	0	0	-2,687	-1,792	-897	0
	(Annual growth in percentage of beginning of period M3, unless otherwise specified)							
Net foreign assets	37.5	18.7	22.9	5.6	20.4	8.2	2.8	4.9
Net domestic assets	-31.5	6.3	4.2	10.4	-7.2	5.6	8.4	6.4
Credit to government (net)	-9.7	6.7	-1.0	-0.8	-6.9	2.4	-1.7	-3.2
Credit to the economy	-2.5	11.7	22.5	11.3	17.1	13.0	12.2	11.4
Other items (net; asset +)	-19.3	-12.1	-17.3	-0.1	-17.5	-9.8	-2.1	-1.9
Broad money (M3) (12-month change in percent)	5.9	25.0	27.1	16.0	13.2	13.8	11.2	11.2
M2 (12-month change in percent)	16.7	16.4	22.1	15.2	18.5	17.5	15.5	14.5
M3-to-GDP ratio (percent)	25.6	27.7	28.4	27.7	27.2	26.8	26.3	26.0
M2-to-GDP ratio (percent)	17.0	17.1	18.1	17.0	18.1	18.4	18.8	19.1
Credit to the economy (12-month change in percent)	-5.6	29.6	57.0	27.6	35.0	22.3	19.5	16.9
Credit to the economy-to-GDP ratio (percent)	10.1	11.4	13.9	12.5	15.8	16.8	17.7	18.4
Currency outside banks-to-M3 ratio (percent)	15.3	14.1	14.1	14.0	13.8	15.7	16.2	16.4
Currency outside banks-to-M2 (percent)	23.1	22.9	22.1	22.8	20.7	22.9	22.7	22.2
Foreign currency deposits-to-M3 ratio (percent)	33.7	38.3	36.4	38.7	33.4	31.2	28.6	26.4
Reserve money growth (12 month change in percent)	20.2	17.0	16.5	15.0	15.1	14.5	13.7	13.0
Money multiplier (M2/reserve money)	2.2	2.2	2.3	2.2	2.3	2.4	2.4	2.5
Money multiplier (M3/reserve money)	3.3	3.5	3.6	3.5	3.5	3.5	3.4	3.4
Velocity (GDP/M3)	3.9	3.6	3.5	3.6	3.7	3.7	3.8	3.9
Velocity (GDP/M2)	5.9	5.8	5.5	5.9	5.5	5.4	5.3	5.2
Nominal GDP growth	17.2	15.4	14.0	15.9	17.6	15.7	13.1	13.0

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

1/ Mozambique's liability to the Fund rests with the Bank of Mozambique (BM). MDRI assistance is immediately transferred to a government blocked deposit account at the BM.

2/ Balance declines from MDRI assistance by 0.5 percent of GDP corresponding to an agreed increase in government expenditures.

Table 4. Mozambique: Balance of Payments, 2004–09

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

	2004	2005		2006		2007	2008	2009
	Prel.	Prog.	Est.	Prog.	Proj.	Proj.	Proj.	Proj.
Trade balance	-531	-661	-721	-716	-623	-663	-820	-878
Exports, f.o.b.	1,504	1,726	1,745	1,799	2,101	2,246	2,226	2,364
Megaprojects	1,049	1,257	1,263	1,289	1,570	1,676	1,605	1,663
Other exports	455	469	483	509	532	570	621	701
Imports, c.i.f.	-2,035	-2,387	-2,467	-2,514	-2,725	-2,909	-3,046	-3,242
Megaprojects	-322	-411	-423	-407	-478	-557	-508	-499
Other imports	-1,712	-1,976	-2,044	-2,107	-2,246	-2,352	-2,539	-2,743
Services and incomes (net)	-301	-483	-337	-485	-565	-639	-499	-400
Receipts	370	381	464	422	547	649	731	837
Expenditures	-671	-864	-801	-906	-1,111	-1,287	-1,230	-1,237
Of which : interest on public debt	-18	-26	-24	-23	-21	-33	-36	-39
Current account, before grants	-832	-1,144	-1,058	-1,200	-1,188	-1,302	-1,319	-1,278
Unrequited official transfers	527	550	468	654	793	661	680	688
Of which : MDRI grant from the IMF					120	0	0	0
Of which : HIPC grant from the IMF	0	15	15	15	34	0	0	0
Current account, after grants 1/	-305	-594	-591	-546	-395	-641	-640	-590
Capital account	291	441	394	488	364	762	681	673
Trade credit (net)	-3	0	5	20	20	50	55	61
Foreign borrowing	463	561	470	562	585	701	661	680
Public (including IMF)	315	356	228	357	357	375	359	351
Private 3/	148	205	242	205	228	326	302	328
Amortization	-291	-279	-256	-319	-464	-336	-373	-408
Public	-51	-71	-71	-81	-199	-45	-47	-48
Of which: IMF 2/	-9	-30	-30	-36	-154	0	0	0
Private	-240	-207	-184	-239	-265	-290	-326	-360
Direct investment (net)	245	135	150	209	207	323	313	314
Of which: Moatize coal mine	123	0	0	0	0	0	0	0
Other investment of the government 4/	-123	24	24	16	16	24	25	26
Short-term capital and errors and omissions (net)	227	69	142	50	0	0	0	0
Overall balance	213	-83	-55	-8	-31	122	41	83
Financing	-213	83	55	8	31	-122	-41	-83
Of which : Bank of Mozambique								
gross reserve assets (increase -)	-213	83	55	8	31	-122	-41	-83
Financing gap	0	0	0	0	0	0	0	0
Memorandum items:								
Use of Fund credit (net)	-6	-23	-23	-31	-149	2	0	0
Current account deficit (percent of GDP)								
Before grants	14.1	17.0	15.9	17.4	17.1	17.8	16.4	14.4
After grants	5.2	8.8	8.9	7.9	5.7	8.8	7.9	6.6
Net international reserves	960	900	944	923	1,063	1,182	1,223	1,307
Gross international reserves	1,160	1,076	1,105	1,068	1,074	1,195	1,237	1,320
In months of imports of GNFS	5.8	4.6	4.6	4.4	4.1	4.2	4.2	4.2
In months of imports of GNFS, excluding megaprojects	7.0	5.6	5.8	5.2	5.1	5.3	5.1	5.0

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

1/ Since this presentation still follows the fourth balance of payments manual, MDRI and HIPC grants from the IMF are included in the current account. MDRI debt relief from IDA and AfDF will be reflected in the next program review and we are currently in the process of updating the presentation to the fifth BOP manual.

2/ The large amortization in 2006 reflects the repayment of IMF debt with MDRI resources.

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

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

Table 5. Mozambique: Balance of Payments of Megaprojects, 2002–08 1/

	2002	2003	2004	2005		2006	2007	2008
	Act.	Act.	Prel.	Prog.	Rev. Proj.	Proj.	Proj.	Proj.
	(In millions of dollars, unless otherwise specified)							
Trade balance	66	344	726	847	869	1,091	1,119	1,097
Exports, f.o.b.	468	681	1,049	1,257	1,263	1,570	1,676	1,605
Imports, c.i.f.	-402	-337	-322	-411	-393	-478	-557	-508
Services and incomes (net)	-233	-228	-305	-444	-504	-739	-797	-700
Current account, before grants	-167	116	421	403	365	352	322	398
Current account, after grants	-167	116	421	403	365	352	322	398
Capital account	644	229	-57	-24	50	-66	109	14
Foreign borrowing	439	62	5	75	110	45	134	101
Amortization	-40	-66	-117	-143	-120	-170	-171	-187
Direct investment (net)	245	234	55	45	60	59	146	101
Overall balance before short-term capital inflows 2/	477	344	364	379	416	286	431	412

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

1/ Megaprojects include Mozal (aluminum production); Sasol (gas production and pipeline); the Cahora-Bassa dam (hydro-power); and two titanium ore projects.
2/ This line significantly overestimates the contribution of megaprojects to international reserve accumulation, because most of their financial operations are conducted outside the domestic banking system. Only a small fraction of foreign exchange proceeds are actually repatriated in Mozambique. However, information on the latter is not available.

Table 6. Mozambique: Expenditure in PARPA Priority Sectors, 2004–06 1/

(In billions of meticais, unless otherwise indicated)

	2004 Est.	2005 Est.	2006 Proj.
Total revenues	16,838	21,418	26,052
Total expenditure, excluding bank restructuring costs and net lending	31,549	33,911	48,424
Total expenditure (excludingbank restruct. costs, net lending, and interest payments)	30,228	32,663	46,847
Interest payments on public debt	1,321	1,248	1,576
Total expenditure in PARPA priority sectors	19,033	21,655	32,576
in percent of GDP	14.3	14.2	18.0
in percent of total expenditure	63.0	66.3	69.5
Education	6,317	6,512	9,393
Primary	5,325	5,546	7,779
Postsecondary	992	965	1,614
Health	3,183	4,140	6,878
HIV/AIDS	123	217	684
Infrastructure development	3,982	6,103	7,507
Roads	3,112	4,620	4,691
Sanitation and public works	870	1,483	2,816
Agriculture and rural development	1,322	1,284	1,548
Governance and judicial system	2,936	2,899	5,884
Security and public order	1,753	1,446	2,008
Governance	483	598	2,824
Judicial system	699	855	1,051
Other priority areas	1,170	724	682
Social actions	201	209	343
Labor and employment	123	108	148
Mineral resources and energy	846	407	192
Total PARPA expenditures, in percent of GDP			
Education	4.7	4.3	5.2
Primary	4.0	3.6	4.3
Postsecondary	0.7	0.6	0.9
Health	2.4	2.7	3.8
HIV/AIDS	0.1	0.1	0.4
Infrastructure development	3.0	4.0	4.2
Roads	2.3	3.0	2.6
Sanitation and public works	0.7	1.0	1.6
Agriculture and rural development	1.0	0.8	0.9
Governance and judicial system	2.2	1.9	3.3
Security and public order	1.3	0.9	1.1
Governance	0.4	0.4	1.6
Judicial system	0.5	0.6	0.6
Other priority areas	0.9	0.5	0.4
Social actions	0.2	0.1	0.2
Labor and employment	0.1	0.1	0.1
Mineral resources and energy	0.6	0.3	0.1
Total PARPA expenditures, in percent of total expenditures			
Education	20.9	19.9	20.1
Primary	17.6	17.0	16.6
Postsecondary	3.3	3.0	3.4
Health	10.5	12.7	14.7
HIV/AIDS	0.4	0.7	1.5
Infrastructure development	13.2	18.7	16.0
Roads	10.3	14.1	10.0
Sanitation and public works	2.9	4.5	6.0
Agriculture and rural development	4.4	3.9	3.3
Governance and judicial system	9.7	8.9	12.6
Security and public order	5.8	4.4	4.3
Governance	1.6	1.8	6.0
Judicial system	2.3	2.6	2.2
Other priority areas	3.9	2.2	1.5
Social actions	0.7	0.6	0.7
Labor and employment	0.4	0.3	0.3
Mineral resources and energy	2.8	1.2	0.4

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

1/ PARPA stands for National Action Plan for the Reduction of Absolute Poverty.

Table 7. Mozambique: Financial Soundness Indicators for Banking Sector, 2000–05
(In percent unless otherwise indicated)

	2000	2001	2002	2003	2004	2005
Capital adequacy						
Regulatory capital to risk-weighted assets	-2.13	8.44	14.01	17.03	18.65	16.00
Regulatory Tier I capital to risk-weighted assets	-2.07	6.03	11.97	14.67	15.97	13.57
Capital (net worth) to assets	-2.70	8.22	9.42	9.01	9.51	8.04
Asset composition and quality						
Sectoral distribution of loans to total loans						
Agriculture	20.80	16.57	17.60	14.45	14.37	12.80
Industry	27.40	24.92	25.35	21.21	19.08	13.07
Construction	4.53	3.42	4.27	5.47	3.64	4.23
Commerce	20.41	13.20	12.54	15.41	19.42	28.02
Transportation and communication	5.23	6.91	5.29	5.71	6.37	5.97
Other	21.63	34.97	34.96	37.75	37.12	35.91
of which: Private 1/	6.28	10.57	9.40	7.75	12.42	13.35
Housing	4.17	2.92	6.33	7.21	8.38	4.34
Diverse 2/	11.19	21.48	19.23	22.79	16.32	18.22
Foreign exchange loans to total loans	40.24	64.69	69.87	70.77	67.33	63.91
Nonperforming loans to gross loans 3/	17.76	23.43	20.80	14.43	6.42	3.82
Nonperforming loans net of provisions to capital 3/	35.00	11.00	9.39	7.91	1.70	0.89
Earnings and profitability		60.23	70.75	95.28	58.72	54.25
Return on assets	0.04	0.14	1.59	1.24	1.43	1.81
Return on equity	...	3.51	22.10	16.29	18.73	27.42
Personnel expenses to noninterest expenses	...	51.71	47.81	47.20	43.13	47.37
Spread between reference loan and deposit rates (90 days, local currency)	...	14.00	19.00	17.39	14.67	11.48
Funding and liquidity						
Liquid assets to total assets 4/	41.51	34.64	46.23	29.46	34.67	24.61
Customer deposits to total (non-interbank) loans	188.00	217.00	240.00	227.97	283.07	191.90
Foreign exchange liabilities to total liabilities	54.53	63.30	61.26	46.39	41.38	45.26

Source: Bank of Mozambique (BM).

1/ Includes credit cards and consumer credit lines for vehicle and durable goods.
2/ Includes credit to all other sectors not discriminated above or yet to be identified.
3/ Nonperforming loans are defined according to Mozambican accounting standards (they include only part of the past-due loans).
4/ Includes deposits at parent banks.

Table 8. Mozambique: Indicators of External Vulnerability, 2003-06
(In percent of GDP, unless otherwise indicated)

	2003	2004	2005 Prel.	2006 Proj.
Financial indicators				
Net present value of public sector debt 1/ 2/	25.2	25.2	21.0	12.1
Broad money (percent change, 12-month basis)	18.7	5.9	27.1	13.2
Private sector credit (percent change, 12-month basis)	-1.4	-5.6	57.0	35.0
External indicators				
Exports of goods (percent change, 12-month basis in U.S. dollars)	28.9	44.1	16.1	20.4
Imports of goods c.i.f. (percent change, 12-month basis in U.S. dollars)	12.8	16.9	21.2	10.9
Terms of trade (percent change, 12-month basis)	-2.1	12.7	9.4	4.7
Current account balance (after grants)	-9.2	-5.2	-8.9	-5.8
Capital and financial account balance	9.0	4.9	5.9	5.2
Of which : foreign direct investment (net)	7.1	4.1	2.3	3.0
Gross international reserves (in millions of U.S. dollars)	947	1,160	1,105	1,074
(In months of imports of goods and services)	5.4	5.8	4.6	4.1
(In months of imports of goods and services, excluding megaprojects)	6.8	7.0	5.8	5.1
Net international reserves (in millions of U.S. dollars)	738	960	944	1,063
Net international reserves (in percent of foreign currency deposits)	137	157	144	183
Net foreign assets of commercial banks (in millions of U.S. dollars)	306	264	343	343
Net present value of total external debt 1/ 2/	54.4	46.7	36.3	31.1
Of which : net present value of public sector external debt 2/	25.2	25.2	21.0	12.1
Net present value of public external debt-to-exports of goods and services (in percent) 2/	102.0	83.8	83.6	32.3
Public external debt-service payments to exports of goods and services (in percent) 3/	6.9	3.8	4.4	1.6
Exchange rate (meticais per U.S. dollar, period average) 4/	23,341	22,131	22,794	...
REER depreciation (-) (12 month basis)	-8.5	17.5	-8.5	...

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

1/ Domestic public debt and private sector external debt are valued at par in the net present value calculation.
2/ Historical NPV estimates are based on previous debt sustainability analyses.
3/ Cash interest and amortization payments, after HIPC assistance.
4/ Official exchange rate.

Table 9. Mozambique: Millennium Development Goals, 1990–2004

	1990	1994	1997	2000	2003	2004
Goal 1: Eradicate extreme poverty and hunger						
Income share held by lowest 20 percent	..	..	6.0	..	..	..
National household survey poverty incidence 2/	..	..	*69.4*	..	54.1	..
Malnutrition prevalence, weight for age (percentage of children under 5)	..	..	26.0	26.0	24.0	*24.0*
Poverty gap at 1 U.S dollar a day (PPP) (in percent)	..	..	*12.0*	..	..	..
Poverty headcount ratio at 1 U.S dollar a day (PPP) (percentage of population)	..	..	*38.0*	..	..	..
Poverty headcount ratio at national poverty line (percentage of population)	..	..	69.0	..	..	..
Prevalence of undernourishment (percentage of population)	..	..	58.0	..	45.0	*45.0*
Goal 2: Achieve universal primary education						
Literacy rate, youth total (percentage of people ages 15-24)	49.0	..	..	..	..	..
Persistence to grade 5, total (percentage of cohort)	..	..	..	52.0	..	..
Primary completion rate, total (percentage of relevant age group)	24.9	24.5	*25.4*	16.2	*22.1*	29.0
School enrollment, primary (percentage, net)	..	..	..	56.0	*56.0*	71.0
Goal 3: Promote gender equality and empower women						
Proportion of seats held by women in national parliament (in percent)	16.0	..	25.0	*25.0*	30.0	30.0
Ratio of girls to boys in primary and secondary education (in percent)	..	..	..	75.1	*78.6*	82.3
Ratio of young literate females to males (percentage ages 15–24)	47.9	..	..	..	..	..
Share of women employed in the nonagricultural sector (in percent of total nonagricultural employment)	11.0	..	..	..	..	..
Goal 4: Reduce child mortality						
Immunization, measles (percentage of children ages 12–23 months)	59.0	65.0	61.0	71.0	77.0	77.0
Mortality rate, infant (per 1,000 live births)	158.0	..	..	122.0	..	104.0
Mortality rate, under-5 (per 1,000)	235.0	..	..	178.0	..	152.0
Goal 5: Improve maternal health						
Births attended by skilled health staff (in percent of total)	..	..	44.2	..	48.0	*48.0*
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	..	1,000	..	..
Goal 6: Combat HIV/AIDS, malaria, and other diseases						
Children orphaned by HIV/AIDS	..	..	..	..	470,000	*470,000*
Contraceptive prevalence (percentage of women ages 15-49)	..	..	6.0	..	17.0	*17.0*
Incidence of tuberculosis (per 100,000 people)	167.1	..	..	..	..	460.2
Prevalence of HIV, female (percentage ages 15-24)	..	..	..	..	..	..
Prevalence of HIV, total (percentage of population ages 15-49)	..	..	..	..	12.0	*12.0*
Tuberculosis cases detected under DOTS (in percent)	..	..	46.8	44.5	45.5	45.9
Goal 7: Ensure environmental sustainability						
CO2 emissions (metric tons per capita)	0.1	0.1	0.1	0.1	*0.1*	..
Forest area (percentage of land area)	26.0	..	..	25.0	..	..
GDP per unit of energy use (constant 2,000 PPP U.S. dollars per kilogram of oil equivalent)	1.0	2.0	2.0	2.0	2.0	*2.0*
Improved sanitation facilities (percentage of population with access)	..	..	..	..	*27.0*	..
Improved water source (percentage of population with access)	..	..	..	..	*42.0*	..
Nationally protected areas (percentage of total land area)	..	..	..	..	8.4	8.4
Goal 8: Develop a global partnership for development						
Aid per capita (current U.S. dollars)	74.7	78.3	56.6	49.0	54.5	63.2
Debt service (PPG and IMF only, percentage of exports, excluding workers' remittances)	17.0	30.0	18.0	2.0	5.0	3.0
Fixed line and mobile phone subscribers (per 1,000 people)	3.5	3.7	4.1	7.6	26.9	*26.9*
Internet users (per 1,000 people)	0.0	..	0.1	1.1	4.4	7.1
Personal computers (per 1,000 people)	..	..	1.8	3.3	5.0	5.8
Total debt service (percentage of exports of goods, services and income)	26.0	31.0	19.0	12.0	6.0	5.0
Unemployment, youth female (percentage of female labor force ages 15-24)	..	..	..	..	..	..
Unemployment, youth male (percentage of male labor force ages 15-24)	..	..	..	..	..	..
Unemployment, youth total (percentage of total labor force ages 15-24)	..	..	..	..	..	..
Other						
Fertility rate, total (births per woman)	6.2	..	5.9	5.7	5.4	5.4
GNI per capita, Atlas method (current U.S dollars)	170	140	170	210	230	270
GNI, Atlas method (billions of current U.S. dollars)	2.3	2.1	2.9	3.8	4.4	5.3
Gross capital formation (% of GDP)	22.1	25.5	20.6	33.5	25.9	20.1
Life expectancy at birth, total (years)	43.2	..	43.8	42.6	41.9	41.8
Literacy rate, adult total (percentage of people ages 15 and above)	33.5	..	..	..	..	..
Population, total (millions)	13.4	15.3	16.7	17.9	19.1	19.4
Trade (in percent of GDP)	44.2	62.1	41.9	61.3	72.3	68.3

Source: World Development Indicators database, April 2006; and Mozambican authorities.

1/ Figures in italics refer to periods other than those specified.
2/ A household survey was conducted between 1996–97 and 2002–03 to determine poverty incidence. The methodology included a basket of goods that satisfies basic calorie needs. The cost of this basket represents the food poverty line in each domain; a nonfood poverty line was also obtained. Households are defined as poor if their daily per capita expenditure is less than the total poverty line (sum of food and nonfood poverty lines).

Maputo, Mozambique
April 3, 2006

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

Dear Mr. de Rato:

1. On behalf of the Government of Mozambique, we hereby transmit the attached memorandum of economic and financial policies (MEFP) that sets out the objectives and policies that the Government intends to implement in 2006, as well as the underlying macroeconomic policy framework consistent with the PARPA II. The attached revised technical memorandum of understanding (TMU) defines the terms and conditions of the program.

2. The Government of Mozambique continues to make progress in implementing the 2004-06 program supported by the three-year arrangement under the Poverty Reduction and Growth Facility (PRGF), which was approved by the Fund's Executive Board on July 6, 2004. All quantitative performance criteria at end-December 2005 were observed. However, we encountered some delay on the structural side. The program for 2006 and the medium term framework have been revised to take into account the multilateral debt relief initiative (MDRI), domestic and international economic developments, and PARPA II.

3. We would like to thank the IMF for the prompt implementation of the MDRI; part of the resources released has been incorporated in the execution of the 2006 budget. As discussed with the Fund staff during the third review mission, we will spend the additional resources made available by the MDRI on contingent poverty-reducing "priority" expenditures identified in the budget.

4. In support of its objectives and policies, the Government of Mozambique hereby requests the disbursement of the fifth loan under the PRGF in the amount of SDR 1.62 million (1.4 percent of quota) on the completion of the fourth review.

5. Looking ahead, the policies set out in the MEFP continue to aim to consolidate macroeconomic stability and sustain strong broad-based growth in order to continue to reduce poverty. The performance criteria and benchmarks for the fifth review will be based on the end-June 2006 and end-September 2006 targets as set out in Tables 1 and 3 of the

MEFP. The sixth review, which will make available the seventh disbursement, is expected to be completed by June 30, 2007, and will be based on the observance of the end-December 2006 performance criteria set forth in Table 1 and Table 3 of the MEFP. Additional conditionality for the seventh disbursement will be established at the time of the fifth review.

6. We request a modification of the performance criterion on the rollout of e-SISTAFE to the Ministries of Agriculture, Health, and Public Works at end-June 2006 due to technical delays related to the introduction of a new family of metical.

7. We request a modification of the nature of the quantitative performance criteria for end-June as set out in Table 1 and the TMU.

8. The Government of Mozambique intends to accept its obligations under Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement following the approval of the new foreign exchange law which will be submitted to the Assembly by end-September 2006.

9. The Government of Mozambique will provide the Fund with such information as the Fund may request in connection with the progress made in implementing the economic and financial policies and achieving the objectives of the program.

10. The Government of Mozambique believes that the policies and measures set forth in the MEFP are adequate to achieve the objectives of its economic program for 2006 supported by the PRGF arrangement, but it will take further measures to that end if deemed necessary. During the implementation of the arrangement, the Government of Mozambique will consult with the Managing Director on the adoption of these measures and in advance of revisions to the policies contained in the MEFP, at the initiative of the Government or whenever the Managing Director requests such a consultation.

Sincerely yours,

/ s /
Manuel Chang
Minister of Finance

/ s /
Adriano Afonso Maleiane
Governor
Bank of Mozambique

Attachments: Memorandum of Economic and Financial Policies
Technical Memorandum of Understanding

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

April 3, 2006

1. The Government of Mozambique is committed to continue to consolidate macroeconomic stability and to achieve sustained economic growth and poverty reduction through the pursuit of prudent macroeconomic policies and structural reforms. The strategy to achieve these goals in 2006–09 is set out in the *Plano de Acção Para a Redução da Pobreza Absoluta II* (PARPA II) approved by the Government in April 2006. The Government's economic program is supported by the International Monetary Fund (IMF) with a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF), which was approved on July 6, 2004. This Memorandum of Economic and Financial Policies (MEFP) reviews the performance under the program (October 2005–March 2006) and describes the policies and targets for 2006.

I. Recent Performance Under the PRGF-Supported Program

2. In 2005, economic performance remained favorable. Real GDP growth is expected to have reached about 7½ percent in 2005 led by the construction and manufacturing sector, and by the continued contribution of megaprojects. The localized drought that affected parts of the country in 2005 has eased with good rainfall (and localized flooding) recently. However, about 800,000 people still live on food aid until the next harvest in April 2006. While the annual average headline inflation rate moderated from 12.6 percent in 2004 to 6.4 percent in 2005 driven by lower food prices, it accelerated in the last few months due to the spike in domestic petroleum prices and pass-through of the exchange rate depreciation in October-November 2005. In response to mounting exchange rate volatility, the BM temporarily introduced an exchange rate band in the interbank foreign exchange market in November 2005. The NIR target for end-December 2005 was met and most of the real effective appreciation of the metical in 2004 was reversed in 2005.

3. Fiscal performance for 2005 was better than programmed. The domestic primary deficit has narrowed by about 2 percent of GDP (about 1 percent better than programmed) compared to 2004 on account of higher domestic revenues and a lower level of current expenditures. The lower level of expenditures was a result of the delay in the adoption of the 2005 budget following the general election in December 2004.

4. Progress has been made in reforming revenue administration and widening the tax base. The general tax law and the law creating the Central Revenue Authority (ATM) were approved by the Assembly in December 2005, and promulgated in February 2006. The implementing regulations for the ATM law were prepared and are currently being discussed at the National Council of Public Function, to be approved by the Council of Ministers by

end-June 2006 (structural benchmark). The organic law of tax tribunals was also approved by the Government, paving the way to establish tax tribunals. In addition, the following measures were implemented: (i) identifying and collecting tax arrears related to the personal and corporate income taxes for 2003–04; (ii) increasing the number of taxpayers to 295,000; (iii) and conducting a larger number of tax audits.

5. Public Expenditure Management (PEM) reforms continue to move ahead, albeit with some delay. The pilot rollout of e-SISTAFE (Financial Administration System) to the Ministries of Education and Culture, Finance, and Planning was implemented in November 2005 but the disbursement of funds *(adiantamento de fundos)* were only partially eliminated (structural benchmark for end-December 2005). The full functionality of the system has been delayed until July 2006 due to difficulties in the development of the new version of the software (first version of Homoine software for e-SISTAFE). The 2006 budget and the current version of e-SISTAFE use an improved functional and "origin-of-resources" budget classifiers. As such, the capacity to track and report on "priority" poverty-reducing expenditures and the MDRI resources have been enhanced. In addition, off budget project expenditures financed by external aid are starting to be integrated gradually into the e-SISTAFE with the help of the donor community, including the World Bank.

6. Monetary policy has remained prudent. The performance criterion on Net Domestic Assets (NDA) and the indicative target on base money were met for end-December 2005 but broad money was higher than programmed due to greater than anticipated net foreign assets and stronger growth in credit to the economy. The recorded increase in credit to the economy was mainly related to the financing of large oil import transactions and the inclusion of the operations of a leasing company purchased by Banco Internacional de Moçambique (BIM) in the monetary survey since December.

7. Prudential ratios of the banking system have continued to improve. The ratio of non-performing loans to total loans has fallen below 5 percent as commercial banks have written off bad loans as part of their restructuring plans which are now largely complete. Since July 2005, commercial banks are required to provision 50 percent of their foreign currency-denominated loans to nonexporters. This has led to a deceleration in foreign currency loan growth but commercial banks have remained within their foreign currency exposure limits. Overall, the commercial banking system appears to be well capitalized and profitable. In addition, in order to strengthen the balance sheet of the BM, securities in an amount of MT 1.5 trillion were issued to BM in June 2005 as envisaged in the program.

8. Progress on other structural reforms in 2005 was slower than envisaged, particularly with regard to public sector reform, labor market reform, and public enterprises. The finalization of a draft law to increase labor market flexibility was delayed due to the time needed to build consensus among all stakeholders. In addition, the independent census of the

civil service found that the three databases of civil servants were not reconcilable and recommended the creation of an integrated payroll database system. The adoption of the revised anti-corruption strategy by the Council of Ministers was delayed by a month (a structural benchmark for end-March 2006). On a positive note, a decree establishing procurement regulations in line with international standards was adopted in December 2005, and the new Commercial Code, the Commercial Registration Code, and the Civil Procedure Code were approved in December 2005. Commercial sections in the Judicial Tribunals of the city of Maputo were also established along with Sofala and Nampula.

II. The Policy Agenda for 2006

9. The policy framework, which aims at consolidating macroeconomic stability, is consistent with the medium-term goal of sustaining poverty reduction through strong economic growth. The Government is committed to continue to implement measures to strengthen the transparency and monitoring of the budget execution including the MDRI resources, to fine-tune monetary policy, and to reinvigorate and accelerate the structural reform agenda. Furthermore, the Government intends to continue to monitor its program with the existing multi-disciplinary committee, particularly through reinforced coordination between the BM and the Ministry of Finance (MF).

10. Prospects for 2006 are for continued broad-based and strong economic growth, a containment of inflationary pressures stemming from external shocks, and the maintenance of a sustainable fiscal and external position. Real GDP growth is expected to pick-up slightly to 7.9 percent in 2006 as a result of the recovery in agricultural production, and continued strong growth in construction related to megaprojects activities. The impact of the spike in petroleum prices and exchange rate depreciation in the last few months is expected to increase the average headline inflation rate to 9.5 percent in 2006. Despite a further increase in the oil import bill expected in 2006, the external current account deficit, excluding grants, is projected to decrease, mainly on account of higher exports. Overall, NIR will remain above four months of imports goods and nonfactor services (and five months excluding mega projects imports).

11. The 2006 fiscal stance will reflect additional expenditures identified in the 2006 budget that were contingent on the MDRI. As such, expenditures will be higher by about 0.5 percent of GDP financed by MDRI relief from the Fund to increase poverty-reducing expenditures in “priority” sectors. The wage bill will remain at about 7.5 percent of GDP—despite the hiring of about 10,000 teachers as originally programmed. As a result, the domestic primary deficit will be 2.6 percent of GDP with a negative net domestic banking financing of 2.5 of GDP. The share of spending on priority sectors out of total primary expenditures will exceed 65 percent. Total domestic revenue is envisaged to rise by about 0.4 percent of GDP owing to the collection of tax arrears amounting to about 0.2 percent of

GDP, the quarterly adjustment of the tax rate on fuels which was not fully implemented in 2005, a broadening of the tax base through raising taxpayer registration by 100,000, and an improvement in tax administration.

12. In 2006, emphasis in the revenue area will be given to the following priorities: (i) continuing to modernize the tax administration by establishment of the ATM through the implementation of the strategic plan; (ii) strengthening auditing, inspection and enforcement procedures to minimize fraud and tax evasion, particularly for large taxpayers; (iii) upgrading the taxpayer information system and improving taxpayer services; (iv) installing electronic scanners at border points and reorganization of customs operations; and (iv) establishing tax tribunals in Maputo, Beira, and Nampula for domestic taxes (structural benchmark for end-June 2006).

13. During 2006, the Government will also intensify its efforts to improve public expenditure management through the continued implementation of SISTAFE. The Government will develop and test a new version of the e-SISTAFE (Homoine version) software to enable effective direct budget execution (according to the sequence of commitment, verification, and payment) for goods and services in the Ministries of Finance, Planning, Education, Agriculture, Health, and Public Works, at the central and provincial levels (a structural performance criterion) by end-July 2006. By end-December 2006, all budgetary operations for goods and services of Financial Management Departments (DAFs) of at least 22 additional ministries and organs (see attached list in the TMU), at the central and provincial levels, will be executed through the e-SISTAFE (structural benchmark) with the help of the international community. In addition, with the support of the donor community, off-budget project expenditures outside the Treasury Single Account will be progressively included in the e-SISTAFE and the multi-currency functionality will be ready by January 2007. The Government will continue to implement its fiscal decentralization strategy with due regard to sequencing, in particular the need to buttress local administrative capacity, procurement and financial reporting and auditing. The Government will complete a prioritized plan by end-September 2006 to gradually rollout e-SISTAFE to all districts (structural benchmark).

14. On monetary policy, the BM will continue to target base money with a view to achieving the inflation target for 2006. To achieve the inflation objective of 7 percent by end-2006, base money growth will be limited to 15 percent or slightly lower than nominal GDP growth. The complete removal of interest rate caps in the treasury-bill auctions (for all maturities) in March 2006 will make monetary policy more effective and provide a yield curve for pricing of financial services. All interest rates are now market-determined. In addition, the monetary authority remains committed to a flexible exchange rate regime which will help cushion against exogenous shocks and maintain a comfortable level of international reserves.

15. The BM is committed to monetary reforms. It will continue to improve its liquidity management framework by preparing quarterly, weekly, and daily liquidity forecasts, and by deepening debt markets as part of the Financial Sector Technical Assistance Program (FSTAP). The MF will also improve the preparation of daily, weekly, and monthly cash-flow projections and execution, and has requested technical assistance (TA) from the Fund in this area. Moreover, with World Bank technical assistance, the BM will finalize a master repurchase agreement by end-October 2006. With help from the Fund and the World Bank, the BM will develop a domestic debt strategy for monetary policy and market development. In this regard, BM and the MF will agree, through a memorandum of understanding, to shift the costs of managing monetary policy to the budget starting in 2008. To this effect, the MF will request technical assistance from the IMF. The BM is committed to analyzing alternatives to reduce the impact of the costs of required reserves on the spread between deposit and credit interest rates following best international practices. Finally, in order to conduct monetary policy in a more transparent manner, the BM, with Fund technical assistance, will adopt by end-December 2006 a Long-Term Monetary Policy Strategy, which will define the intermediate target compatible with the base money operational target, design a new format for the monetary policy committee, and specify its communication policy.

16. The BM will introduce a new family of metical on July 1, 2006 (1000 old family of metical will be equal to one new family of metical). The BM has already made the necessary preparations, including the arrangements of legal, accounting, information technology and operational nature. In addition, the launch of a public information campaign covering the entire the country is well underway. This will ensure a smooth conversion of Government and public bank accounts through an effective coordination with commercial banks.

17. The BM will also continue to strengthen and modernize its supervisory functions and accounting. In this regard, the new inspection manuals were finalized. A proposal on the new organizational structure of the banking supervision department consistent with the Integral Strengthening Plan for Banking Supervision is expected to be approved by end-December 2006. In the area of accounting, the BM will adjust its Chart of Accounts by end-September 2006 (structural benchmark) to allow for: (i) the valuation of foreign exchange gains/losses consistent with International Financial Reporting Standards (IFRS); and (ii) the preparation of BM's financial statements for 2005 in compliance with IFRS in parallel to the financial statement prepared under the current accounting standard.

18. 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 Act, the Government will issue securities at market interest rates. The first issuance of securities in an amount of Mt 1.5 trillion was effected in June 2005, the second issuance at market interest rates will take place no later than end-June 2006. The net financial position of the BM has improved considerably in the first semester of 2005, thanks largely to the depreciation of the metical.

19. The BM is implementing a timetable to adopt International Financial Reporting Standards (IFRS) in the banking system and strengthen loan classification and provisioning in line with international best practices. The BM will continue to move forward with the necessary training and other preparations with the aim of fully implementing IFRS in the BM and the banking system starting in 2007. The Chart of Accounts of the commercial banking system will be made consistent with IFRS by end-September 2006 (structural benchmark). Moreover, a new regulation on the assessment, classification and provisioning of credits as well as a regulation on integral risk management for credit institutions and finance companies are expected to be approved in early 2007.

20. The Government is committed to supporting the sound expansion of the non-bank financial sector. The BM will license and supervise microfinance deposit-taking institutions to facilitate enhanced access to finance by rural households and small-and-medium sized enterprises. The strengthening of the social security and supplementary pension system is also being undertaken as part of a new law on social protection, which is under preparation. As part of the pension reform, the restructuring of the National Social Security Fund (INSS) will be expedited to improve operations, investment performance, and governance. As such, guarantees of minimum benefits will be limited until a full actuarial study is completed in 2006 with a view to switching to a defined contributory system. The Government also plans to enhance the regulatory and supervisory framework for supplementary pensions and INSS together with the insurance sector, including by strengthening the capacity of the *Inspecção Geral de Seguros* (IGS), the industry regulator.

21. The BM is committed to implementing the remaining actions needed to address weaknesses identified in the context of the Fund's safeguards assessment mission conducted in June 2004. In particular, the electronic link of the monetary data to the balance sheet was implemented in November 2005. Progress is also being made in making the necessary adjustments so that the balances in the BM's accounting records match the balances confirmed by the correspondents and other third parties. The reconciliation of monetary data with audited financial statements and its review by the internal audit department will be completed by end-December 2006.

22. Regarding the foreign exchange system, a new foreign exchange law taking into account comments from all stakeholders and the Fund, will be submitted to the Assembly by end-September 2006. Following approval of the new law and issuance of related regulations, the authorities intend to accept their obligations under Article VIII sections 2, 3, and 4 of the Fund's Articles of Agreement.

23. The Government expects to further liberalize the trade regime during 2006. In January 2006, the maximum import tariff rate applicable to SADC trading partners was lowered from 25 to 20 percent, and the Government has submitted a legislative authorization

draft to the Assembly to extend this measure to all trading partners. In addition, the Government will proceed with bilateral free trade arrangements as recommended in the Action Matrix of the Diagnostic Trade Integration Study. In this context, it expects to sign a bilateral free trade agreement with Zambia in 2006, similar to the ones that were concluded with Zimbabwe and Malawi in 2005.

24. The Government looks forward to completing the buyback operation for its commercial debt by mid-2006 with the financial assistance of the World Bank and the Government of Norway. The Government recognizes the importance of reaching rescheduling agreements with all bilateral creditors in the context of the enhanced HIPC Initiative. It has intensified its discussions with all Paris Club and non-Paris Club creditors that have not yet delivered debt relief, and hopes that progress would be made in reaching agreements with its remaining Paris Club creditors (Portugal and Japan) as soon as possible. Despite Government's efforts, there has been no progress in the negotiations with several large non-Paris Club creditors (including, among others, Algeria, Libya, Iraq and Romania). In this regard, the Government looks forward to the continued support of the Bretton Woods Institutions.

25. 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, particularly by addressing rigidities in the labor market and improving basic infrastructure. In addition, the Government remains committed to promoting good governance and transparency in the management of natural resources and megaprojects, improving the functioning of the judicial system, and reforming the civil service.

26. Regarding labor regulations, the delayed draft new labor law is expected to be submitted to the Assembly by end-September 2006. This law will increase labor market flexibility by addressing in particular retrenchment costs and facilitating contractual hiring.

27. The Government will continue to restructure and encourage private participation in public enterprises, particularly infrastructure services. The structural benchmark on deciding the strategic option for the restructuring of PETROMOC, the state-owned petroleum distributor, by end-March 2006 was not met but will be undertaken by mid-May 2006. The Government with the help of the World Bank will put in place measures to assist the state-owned electricity company (EDM) to improve performance, including through the operationalization of the regulator (CNELEC).

28. Improving governance remains a priority of the Government. The Government is considering following the Extractive Industries Transparency Initiative (EITI) principles with regard to management of natural resources. All new related agreements, in particular the future exploitation of coal, oil and natural gas as well as any expansion of related megaprojects will follow these principles.

29. In the context of the implementation of the Anti-Money Laundering Law, the Government is committed to creating a financial investigation unit by end-September 2006.

30. In the area of public sector reform, the review of Phase I of the public sector reform (2001–05) was completed in September 2005 and provided lessons for the design of Phase II (2006–11), particularly the need to clearly prioritize and achieve visible results early on. Based on the recommendations of the Phase I review, the Government has prepared a proposal for the Phase II, which is being discussed among all stakeholders. The proposal highlights the need to strengthen the decentralization process (with a focus on building capacity in the districts), greater integration among the various activities, and a better sequencing. The Phase II program, including a timetable, will be submitted to the Council of Ministers by end-June 2006. In this context, the timetable will be defined to include the completion of a strategy paper on decentralization. This strategy will propose, among other things, a clear legal, regulatory, and institutional framework for revenue raising and spending responsibilities of subnational units and monitoring of subnational fiscal operations. To improve payroll management the Government will develop a plan to implement an integrated payroll database compatible with e-SISTAFE by end-September 2006. This will also allow to clean up the database and arrive at a unique number of total civil servants that may identify possible inexistent workers.

31. The Government is making progress in reforming the judicial system. The Organic Law for Judicial Tribunals, and commercial sections in the Judicial Tribunals of the city of Maputo will be operational by end-June 2006 and in the provinces of Sofala and Nampula by end-September 2006. The Penal Procedure Code and the new Insolvency Law are expected to be approved by end-December 2006.

32. A decree on urban land use will be approved by the council of ministers by end-June 2006, so as to facilitate the reduction of costs and time involved in transactions. In addition, the Government remains committed to conducting a Poverty and Social Impact Analysis (PSIA) of urban land tenure regulations, with the help of the World Bank.

III. Medium-Term Macroeconomic Policy

33. The Government's medium-term objectives and priorities are defined in the 2005–09 Five-Year Plan, which sets forth as the foremost priority the reduction of absolute poverty through policies that ensure macroeconomic stability, greater private investment, and sustainable economic growth. The authorities carried out the third annual report on the implementation of their PARPA, which, together with the Five-Year Plan, has been instrumental in the preparation of PARPA II covering the period 2006–09 that was approved by the Council of Ministers in April 2006. The PARPA II shows that Mozambique is on track to meet the MDGs on income poverty, infant and maternal mortality, and access to safe

drinking water. However, other areas, such as primary school enrollment, gender equality, and HIV/AIDS, call for a more effective use of additional donor support as well as an expansion in absorptive capacity.

34. The main macroeconomic objectives over the medium term are to maintain a rate of growth of about 7 percent and to continue to gradually reduce the inflation rate through the pursuit of prudent fiscal and monetary policies in the context of the flexible exchange rate system. The medium-term economic policies will focus on spurring export-led private sector growth, while maintaining debt sustainability. Central to this strategy will be a gradual consolidation of the fiscal position, in order to increase credit to the economy and to maintain a competitive exchange rate. On the basis of current net external financing projections, the domestic primary deficit is projected to decline gradually underpinned by an average increase in revenue of 0.5 percent of GDP per annum. On the other hand, if a scaling-up of external program support materializes it will be used to finance additional expenditures on "priority" sectors as long as there is a continued improvement in public expenditure management and macroeconomic stability is not compromised. To facilitate such a flexible approach, the Government intends to cost programs that will help achieve the MDGs with the help of the donors. The related expenditures would be included as contingent expenditures in the medium term expenditure framework.

35. The structural reform agenda articulated in the PARPA II includes the launching of a "second wave of reforms." The focus will be on increasing tax collection, strengthening public expenditure management and fiscal transparency, implementing an agricultural and rural development strategy, and reducing the cost of doing business including by reforming the judicial sector and strengthening the financial system. An additional emphasis will be put on accelerating the engines of growth by promoting human capital formation, infrastructure investments, and maximizing the net contribution of natural resources and megaprojects to the economy. With respect to the latter, the Government will continue to strengthen the transparency of natural resource management and exploitation, and ensure that the country benefits more from the activities of the megaprojects, including through the State budget.

IV. Program Monitoring

36. The semiannual quantitative performance criteria for end-June 2006 and end-December 2006, as well as the indicative targets that will be used to evaluate the implementation of the program for the remainder of 2006 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 2006.

37. The fiscal program reflecting the MDRI will be monitored through a ceiling on net domestic financing of the government (NCG) excluding changes in project deposits in the banking system as opposed to the domestic primary deficit as outlined in the technical memorandum of understanding (TMU) that has been changed accordingly. This would be simpler and avoid adding the difference between the above-the-line recorded expenditures and below-the-line financing including donor-funded projects to the fiscal target, which is required under the current procedure. The NCG ceiling will be fully adjusted for privatization proceeds but asymmetrically for external program aid and debt service. There will be no adjuster on both NCG and NIR for any excess of program aid (and any shortfall in external debt service). As such, contingent "priority" expenditures identified in the 2006 budget can be executed in the event of any excess in program aid and domestic revenues (and any shortfall in external debt service) compared with the program. However, the NCG ceiling will be adjusted upward (and NIR downward) by 100 percent of any shortfall in external program aid (up to a maximum of US$50 million) and any excess in external debt service payments. In addition, the indicative target on base money will replace Net Domestic Assets as a performance criterion because it is more closely linked to inflation in Mozambique. Finally, the indicative target on the wage bill will be discontinued as it was introduced in a post-conflict situation when there were concerns regarding a loss of fiscal control through a ballooning of the wage bill, which is not the case anymore. Moreover, the complexities of determining the optimal size of the public sector (e.g. hiring of teachers and nurses) to meet the MDGs calls for a more flexible approach but the Government will closely monitor the evolution of the wage bill to contain inflationary pressures and maintain fiscal sustainability.

38. The Government understands that its ability to request the disbursement of the sixth loan under the PRGF arrangement will be contingent upon the observance of the semiannual quantitative performance criteria for end-June 2006 set out in Table 1; and the completion of the fifth review under the program, which is expected to take place before end-December 2006. In reviewing developments under the program during the fifth review, particular attention will be paid to the implementation of measures aimed at broadening the tax base and rolling out the e-SISTAFE, contingency expenditures in the 2006 budget, monetary and financial sector reform, the buttressing of governance and the legal system, and improving the availability and dissemination of information on natural resource exploitation and megaprojects as well as their net contribution.

Table 1a. Mozambique: Quantitative Performance Criteria and Indicative Targets, 2005–06 (Defined during the Third Review under the PRGF Arrangement)
(In billions of meticais, unless otherwise specified)

	2005			2006		
	End-Dec. Perf. Criteria	End-Dec. Perf. Criteria	End-Dec. Perf. Criteria	End-Mar. Indicative Target	End-Mar. Indicative Target	End-Mar. Perf. Criteria
	Prog.	Adj.	Prel. Act.	Prog.	Adj.	Prel. Act.
Government domestic primary deficit (excluding bank recapitalization costs (ceiling) 1/ 2/ 3/ 4/	4,481	4,481	3,052	800	800	...
Stock of net dom. assets of Bank of Mozambique (BM) (ceiling) 1/ 5/ 6/ 7/	-13,218	-13,179	-15,409	-15,911	-15,883	-21,594
Stock of net international reserves of the BM (floor, in millions of U.S. dollars) 1/ 8/	900	898	944	979	978	1,160
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	...	...
Stock of short-term external public debt outstanding (ceiling) 9/ 10/	0	0	0	0	...	...
External payments arrears (ceiling) 3/ 9/ 11/	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	99	99	99	99
Government revenue (floor, indicative target) 3/	21,090	21,090	21,418	5,357	5,357	...
Stock of reserve money (ceiling, indicative target) 7/	12,205	12,205	12,153	11,678	11,678	11,802
Wage bill (ceiling, indicative target) 3/	11,045	11,045	10,358	2,909	2,909	...
Memorandum items:						
Foreign program assistance; grants and loans (in millions of U.S. dollars) 3/	292	...	292	159	...	159
Actual external debt service payments (in millions of U.S. dollars) 3/	68	...	70	12	...	13
Net flows	223	...	222	147	...	146
Exchange rate (meticais per U.S. dollar; end of period)	25,476	...	24,076	25,640		27,074
Shortfall in required reserves	...	...	...	...	...	...
Adjustment to BM's net domestic assets at program exch. rates	...	39	...	...	28	...
Adjustment to BM's NDA target	...	39	...	...	28	...
Adjustment to reserve money	...	0	...	...	0	...
Adjustment to BM's NDA due to shortfall/excess of net program assistance	...	39	...	...	28	...
Stock adjustments in medium- and long-term foreign liabilities	...	0	...	...	0	...

1/ Constitute quantitative performance criteria for end-December 2005.
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 Mt 400 billion in 2005 and Mt500 billion in 2006 to accommodate higher-than-budgeted locally financed drought-related expenditures. To be adjusted upward by any shortfall in debt service payments (including obligations to the IMF) in 2006 attributable to the implementation of the new multilateral debt cancellation initiative.
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 (except for any debt service payments shortfall related to the multilateral debt cancellation initiative) . To be adjusted upwards for up to Mt 400 billion in 2005 and Mt 500 billion in 2006 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 (except for any debt service payments shortfall related to the multilateral debt cancellation initiative). To be adjusted upwards for up to Mt 400 billion in 2005 and Mt 500 billion in 2006 (or the equivalent amount in U.S. dollars at the program exchange rate) to accommodate higher-than-budgeted locally financed drought-related expenditures.
9/ Continuous performance criterion.
10/ Loans of zero to one year's maturity, excluding normal import-related credits converted in U.S. dollars at actual exchange rates.
11/ Excluding arrears arising from debt-service payments that become due pending the conclusion of debt-rescheduling agreements.

Table 1b. Mozambique: Quantitative Performance Criteria and Indicative Targets, 2006 1/
(In billions of meticais; unless otherwise specified)

	2006		
	End-June Perf. Criteria	End-Sep. Indicative Target	End-Dec. Perf. Criteria
	Rev. Prog.	Rev. Prog.	Rev. Prog.
Net claims on the central government (cumulative ceiling)	-3,800	-4,300	-4,518
Stock of base money (ceiling)	12,033	13,209	14,038
Stock of net international reserves of the BM (floor, in millions of U.S. dollars)	1,097	1,073	1,063
New nonconcessional external debt contracted or guaranteed by the central government or the BM with maturity of more than one year (ceiling)	0	0	0
Stock of short-term external public debt outstanding (ceiling)	0	0	0
External payments arrears (ceiling)	0	0	0
Indicative targets:			
Balance of the government's savings account set up abroad with proceeds from the coal exploration contract (floor, in millions of U.S. dollars)	83	83	83
Government revenue (floor)	11,232	18,314	26,052

1/ For definition and adjustors see the attached Program Monitoring Section of Memorandum of Economic and Financial Polices and the Technical Memorandum of Understanding.

Table 2. Mozambique: Structural Performance Criterion and Benchmarks Under the 2005 and 2006 PRGF-Supported Program (October 2005–March 2006)

Actions	Expected Date of Implementation, According to the Program	Comments
Structural performance criterion		
All stages of expenditure (commitment, liquidation, payment, accounting, and reporting) at the Ministries of Agriculture, Health, and Public Works will be executed through the e-SISTAFE, at the central and provincial levels.	End-June 2006	Modified.
Structural benchmarks		
Rollout the SISTAFE to the MEC and abolish the disbursement of funds (adiantamento de fundos).	End-December 2005	Not Met.
A decision will be made on the strategic option for the restructuring of PETROMOC, the state-owned petroleum distributor.	End-March 2006	Not Met. Delayed to May 2006.
The approval of the revised anti-corruption strategy by the Council of Ministers.	End-March 2006	Not Met. Implemented in April 2006.
Establish tax tribunals in Maputo, Beira, and Nampula for domestic taxes.	End-June 2006	On Track

Table 3. Mozambique: Structural Performance Criterion and Benchmarks Under the 2006 PRGF-Supported Program (April–December 2006)

Actions	Expected Date of Implementation, According to the Program	Comments
Structural performance criterion		
The Government will develop and test a new version of the e-SISTAFE software (Homoine version) to enable effective direct budget execution (according to the sequence of commitment, verification, and payment) in the Ministries of Finance, Planning, Education, Agriculture, Health, and Public Works, at the central and provincial levels.	End-July 2006	
Structural benchmarks		
The implementing regulations for the ATM law will be approved by the Council of Ministers.	End-June 2006	
All budgetary operations for goods and services of Financial Management Departments (DAFs) of at least 22 additional ministries and organs (see attached list in the TMU), at the central and provincial levels, will be executed through the e-SISTAFE.	End-December 2006	
The Government will complete a prioritized plan to gradually rollout e-SISTAFE to all districts.	End-September 2006	
Establish tax tribunals in Maputo, Beira, and Nampula for domestic taxes.	End-June 2006	
Adjustments to the BM’s Chart of Account will be approved.	End-September 2006	
The Chart of Accounts of commercial banks will be made consistent with IFRS.	End-September 2006	

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

April 3, 2006

1. This technical memorandum of understanding (TMU) applies from January 1, 2006. 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:

- net claims on the central government by the banking system;
- government revenue;
- 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 and external debt service.

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

Net Claims on the Central Government by the Banking System

2. **Net claims on the central government (NCG)** by the banking system is defined as the difference between the outstanding amount of bank credits to the central government and the central government's deposits with the banking system, excluding deposits in project accounts with the banking system and proceeds from the signing fee for coal exploration. Credits comprise bank loans and advances to the government and holdings of government securities and promissory notes. NCG will be calculated based on data from balance sheets of the monetary authority and commercial banks as per the monetary survey. The limits on the change in net claims on the central government by the banking system will be cumulative beginning end-December 2005 for the 2006 program.

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, 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. 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.

Money supply

7. **Base money** is defined as the sum of currency issued by Bank of Mozambique (BM) and the commercial banks' deposits in the BM. The commercial bank deposits include the statutory required reserves and excess reserves held at the BM. The base money ceilings for 2006 will be the total stock of base money outstanding at end-June 2006, end-September 2006 and end-December 2006, and will be monitored by the monetary authority and provided to the IMF by the BM.

Net international reserves

8. **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 (excluding the government's savings account related to the Moatize coal mine concession). 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.

9. The Bank of Mozambique will publish the exchange rates quoted by commercial banks on average as the market rates.

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

10. 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 central government 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 central government).

11. The central 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

12. The central 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

13. The government undertakes not to incur payments arrears on external debt owed or guaranteed by the central 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

14. Foreign program assistance is defined as grants and loans received by the Ministry of Finance through Bank of Mozambique accounts excluding those related to projects (Tables 1).

Actual external debt-service payments

15. 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, but excluding obligations to the IMF (Table 1).

Adjusters

16. The quantitative targets (floors) for the central bank's net international reserves will not be adjusted for any excess in disbursements of foreign program assistance (and any shortfall in external debt service), compared to the program baseline. These targets will be

adjusted downward by 100 percent of any shortfall in external program aid (up to a maximum of US$50 million) and any excess in external debt service payments, compared to the program baseline (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. They will also be adjusted upward for the full amount of any external 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. The quantitative targets (floors) for the central bank's net international reserves will be adjusted equivalently downward up to a maximum of US$50 million per annum by the amount that the projected fuel import bill is higher due to a rise in the average global oil price (average petroleum spot price of West Texas Intermediate, U.K. Brent, and Dubai Fateh crude). This adjustment will be equal to the difference between the realized and the projected average global oil price, multiplied by the volume of total fuel imports projected for each quarter (Table 2).

17. The quantitative targets (ceilings) for net claims on the central government (NCG) will not be adjusted for any excess in disbursements of foreign program assistance (and any shortfall in external debt service), compared to the program baseline. These targets will be adjusted upward by 100 percent of any shortfall in external program aid (up to a maximum of US$50 million) and any excess in external debt service payments, compared to the program baseline (Table 1). These targets 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. The government expenditures contingent on higher disbursements of foreign program assistance (and lower external debt service) will be used to finance greater "priority" spending identified in the budget.

18. The quantitative target (ceiling) for net claims on the central government (NCG) for end-June 2006 and end-December 2006 will be adjusted upward (and the floors on net international reserves adjusted downward) to accommodate the possible need for higher locally financed government outlays to deal with a drought, up to a total limit of Mt 500 billion.

19. The base money ceiling will be adjusted equivalently upward up to a maximum of Mt 250 billion at end-June 2006, end-September 2006, and end-December 2006 to the extent that the outstanding stock of currency issued by the BM exceeds those projected in Table 3.

Data reporting

20. 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 as well as the weekly data set out in Table 4 of the TMU dated May 26, 2005. Monthly updates will also be provided of the foreign exchange cash flow of the Bank of Mozambique.

21. 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.

22. 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.

23. From December 2005 onwards, the monetary survey made available by the Bank of Mozambique will clearly identify donor-financed project deposits (with a breakdown between foreign and domestic currency) included in net credit to the government in both the central bank's and commercial banks' balance sheets.

Table 1 Mozambique: Foreign Program Assistance and External Debt Service for 2006

(In Billions of meticais)

	2006				
	Q1 Prel Est.	Q2 Prog.	Q3 Prog.	Q4 Prog.	Year Prog.
Foreign program assistance	3978.7	1361.6	1932.1	635.9	7908.2
Program grants	2475.8	1361.6	1151.6	635.9	5624.8
Program loans	1502.9	0.0	780.5	0.0	2283.4
External debt service	307.4	393.2	325.2	435.7	1461.6

Source: Mozambican authorities; and Fund staff estimates.

Table 2: Projected Fuel Import Bill
(In millions of U.S. dollars, unless otherwise indicated)

Quarter	End-June 2006	End-September 2006	End-December 2006
Fuel import bill	92.7	58.5	124.5
Forecasted Oil price (US$ per barrel)	60.0	61.5	62.5
Volume of fuel imports (in metric tons)	160,147	101,814	185,431

Source: Mozambican authorities; and Fund staff projections.

Table 3: Currency Issued by the BM
(In billions of meticais, stock)

Quarter	End-June 2006	End-Sept 2006	End-Dec 2006
Currency issued by BM	6754	7938	8478

Source: Mozambican authorities; and Fund staff projections.

SISTAFE Implementation Plan

Action	Expected date
Implementation of Homoine in 6 sectors: 1. (MEC) Ministry of education and culture; 2. (MF) Ministry of Finance; 3. (MPD) Ministry of Planning and development; 4. (MISAU) Ministry of Health; 5. (MINAG) Ministry of Agriculture and, 6. (MOPH) Ministry of Public Works. All at Central and Provincial level, thereby gradually abolishing disbursement of funds by introducing direct budget execution and not including the external component.	31st of July 2006
Priorities for roll-out to Districts to be defined and elaborated	31st of September 2006
Rollout to the following Ministries and Organs: 1. (MAE) Ministry of Home affairs; 2. (MI) Ministry of Interior 3. (MD) Ministry of Defense 4. (MTS) Ministry of Technology and Science 5. Presidency of the Republic 6. Assembly of the Republic 7. Office of the Prime Minister 8. Conselho Superior da Magistratura 9. Casa Militar 10. Tribunal Administrativo 11. Conselho Constitucional 12. Tribunal Supremo 13. Procuradoria Geral da República 14. (MIC) Ministry of Industry and Commerce; 15. (ME) Ministry of Energy 16. (MRN) Ministry of Natural Resources 17. (MICOA) Ministry of Environmental Coordination 18. (MITUR) Ministry of Tourism 19. (MTC) Ministry of Transport and Communication 20. (MP) Ministry of Fishery 21. (MM) Ministry of Woman and Social Action 22. (MJ) Ministry of Justice	31st of December 2006

Mozambique: Relations with the Fund

(As of March 31, 2006)

I. Membership Status: Joined 9/24/84; Article XIV

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

III. SDR Department	SDR Million	%Allocation
Holdings	0.16	n.a.

IV. Outstanding Purchases and Loans	SDR Million	% Quota
Poverty Reduction and Growth Facility (PRGF) arrangements	4.86	4.28

V. 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	6.48
PRGF	06/28/99	06/28/03	87.20	78.80
ESAF	06/21/96	06/27/99	75.60	75.60

VI. Projected Payments to Fund

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2006	2007	2008	2009	2010
Principal					0.16
Charges/Interest	0.03	0.02	0.02	0.02	0.02
Total	0.03	0.02	0.02	0.02	0.19

VII. 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

VIII. Implementation of MDRI Assistance:

Total Debt Relief (SDR Million)[1/]	106.56
Of Which: MDRI	83.05
HIPC	23.51

Debt Relief by Facility (SDR Million)

Eligible Debt

Delivery Date	**GRA**	**PRGF**	**Total**
January 2006	N/A	106.56	106.56

[1/] The Multilateral Debt Relief Initiative (MDRI) provides 100 percent debt relief to eligible member countries that are qualified for the assistance. The debt relief covers the full stock of debt owed to the Fund as of end-2004 which remains outstanding at the time the member qualifies for such debt relief. The MDRI is financed by bilateral contributions and the Fund's own resources, as well as the resources already disbursed to the member under the HIPC Initiative (see Section VII above).

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 introduced a foreign exchange auction system in January 2005. Auctions are held weekly.

Mozambique still avails itself of the transitional arrangements under Article XIV of the Fund Articles of Agreement, but has eliminated all Article XIV restrictions. It maintains, however, restrictions on the making of payments and transfers for current international transactions subject to Fund approval under Article VIII, as evidenced by (i) the discretionary prior approval for remittances of family living expenses; (ii) the authorization for the purchase of foreign exchange in excess of US$5,000 for certain transactions; (iii) the prohibition for the conversion of balances of nonresidents' domestic currency accounts into foreign currency or transfer abroad; and (iv) the need of 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 all existing the exchange restrictions. The authorities indicated their intention to accept their obligations under Article VIII sections 2, 3, and 4 of the Fund's Articles of Agreement after the approval of the new foreign exchange law which is scheduled to be submitted to the assembly by September 2006.

Article IV Consultation

In accordance with Decision No 12794–(02/76), as amended by Decision No 12854–(02/96), Mozambique is on a 24-month Article IV cycle due to the approval of a new PRGF arrangement in July 2004. The 2005 Article IV consultation was completed by the Executive Board on June 22, 2005 (Country Report No. 05/318).

In concluding the 2005 Article IV consultation, Executive Directors welcomed the substantial reduction in poverty realized over the past decade. At the same time, they stressed that stepped-up efforts are needed to further reduce poverty and, with the necessary financial assistance of the international community, reach the Millennium Development Goals. In particular, they looked forward to the new poverty reduction strategy paper for 2006–10. They noted, however, that a second wave of reforms is needed to deepen and accelerate structural changes to sustain high and broad-based growth. Directors emphasized that efforts should aim at (i) increasing tax revenues; (ii) strengthening public sector operations; (iii) reducing the costs of doing business; (iv) promoting labor intensive sectors; and (v) implementing a rural development strategy.

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 (Country Report No. 04/52). A ROSC on fiscal transparency was issued on February 22, 2001. This ROSC was updated in the context of the 2002 Article IV consultation (Country Report No. 02/140) and the 2003 Article IV consultation (Country Report No. 04/50). A Report on the Observance of Standards and Codes (ROSC) data module was prepared in June 2002 and issued on March 5, 2003. This data module was updated in August 2005.

Management Recent Visit

At the invitation of the authorities, Mr. Kato, Deputy Managing Director, visited Maputo, Mozambique in July 2005.

IMF Technical Assistance Provided to Mozambique (Over the Last Two Years)				
Departments	Timing	Form	Purpose	Counterparts
Fiscal Affairs	March 2006	Mission	Tax Policy review	Ministry of Finance
	November 2005	Inspection mission	Public expenditure management	Ministry of Finance
	October 2005	Fourth 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
	May 2005	Inspection mission	Public expenditure management	Ministry of Finance
	April-May 2005	Mid-term review of the joint IMF/SECO/DANIDA domestic tax and administration reform project	Reform of the tax system and its administration; advice on the creation of a Central Revenue Authority.	Ministry of Finance
	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

IMF Technical Assistance Provided to Mozambique (Over the Last Two Years)				
Departments	Timing	Form	Purpose	Counterparts
	March 2004	Installation mission and coordination with bilateral donors	Public expenditure Management	Ministry of Finance
Legal	February 2004	Mission	Advising government on the implications of accepting the obligations under Article VIII section 2,3 and 4 of the Fund's Articles of Agreement	Ministry of Finance, Bank of Mozambique
	2004	Correspondence	Advice on tax legislation	Ministry of Finance
Monetary and Financial Systems	March 2006	Short-term consultant	Banking supervision	Bank of Mozambique
	Feb-March 2006	Mission	AML/CFT legislation	Bank of Mozambique
	Jan-Feb 2006	Short-term consultant	Monetary policy framework	Bank of Mozambique
	Jan-Feb 2006	Short-term consultant	Monetary operations	Bank of Mozambique
	January 2006	Short-term consultant	Exchange rate management	Bank of Mozambique
	September 2005	Mission	Post- FSAP TA assessment Banking supervision Monetary operations/monetary policy	Bank of Mozambique
	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
Statistics	July 2005	Mission	Government finance statistics	National Institute of Statistics
	June–July 2005	Mission	Consumer price statistics	National Institute of Statistics
	May 2005	Mission	ROSC Data Module Update	National Institute of Statistics

IMF Technical Assistance Provided to Mozambique (Over the Last Two Years)				
Departments	Timing	Form	Purpose	Counterparts
	October 2002–March 2004	Long-term consultant	National accounts statistics	National Institute of Statistics
	November 2004	Mission	Balance of payments statistics	Bank of Mozambique
	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)

Resident Representative: Mr. Felix Fischer has been IMF's Resident Representative to Mozambique since March 1, 2006.

Mozambique: Relations with the World Bank Group

(As of May 10, 2006)

Partnership in Mozambique's Development Strategy

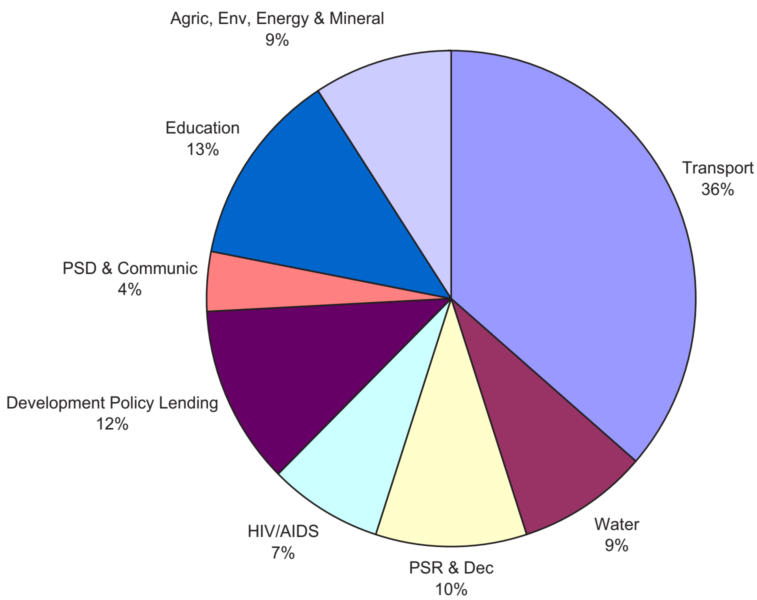
1. The Mozambican government's development strategy is set forth in the poverty reduction strategy paper (PRSP), termed the PARPA (Plano de Acção para a Redução da Pobreza Absoluta e Promoção do Crescimento Económico, or Action Plan for the Reduction of Absolute Poverty), which was approved in April 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: macroeconomic 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, 2004 and 2005, restating its commitment to reduce poverty by pursuing policies that help to create an environment for broad-based growth. In addition, the Program Assistance Partners, which now includes 17 donors and the World Bank, with the IMF as an observer, has undertaken biannual reviews, jointly with the government, of the entire government program since 2004, using a common performance asssesment framework (PAF), in order to serve as the basis for a further shift from project finance toward budget support. It has harmonized and streamlined donor conditionality and is expected to reduce government transaction costs. The government is in the process of finalizing the second PARPA, which includes a monitoring and evaluation framework, the Strategic Matrix, which which will be reviewed by joint sector working groups until the next Joint Review of September 2006.

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. The Fund and the Bank will initiate work on the Joint Staff Assessment on the PARPA II in the second half of 2006.

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, the reform of the civil service, and the Poverty and Social Impact Analysis (PSIA). 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, FY04–07). The three pillars of the CAS are (i) improving the investment climate, (ii) expanding service delivery, and (iii) building capacity and accountability. A CAS Progress Report, an evaluation of the Bank's program during the first two years of implementation has been completed and presented to the Board in March 2006. The focus of the Bank's lending program is on programmatic support through four rolling Poverty Reduction Support Credits (PRSCs), of which the first two credits have been approved and fully disbursed. Fiduciary issues are fully taken into account within the scope and sequencing of the PRSCs. The shift to programmatic lending through the PRSCs was underpinned by the Bank's core diagnostic economic and sector work, including the public expenditure review and PSIA. While a series of PRSCs is the largest single element in the lending program, the shift from traditional investment lending to program lending is being phased in gradually. Selected investment projects are targeting institutional strengthening, capacity building, transport infrastructure, water, agriculture, and communications.



5. To date, the World Bank Group has approved 7 adjustment operations, 2 development policy operations, one investment guarantee and 46 investment operations totaling approximately US$3 billion. The current portfolio includes 20 operations for a total of US$1 billion, with an undisbursed balance of US$588 million. Sixteen of these operations

are investment projects and one is an adjustment operation. Of the four operations planned for the current fiscal year three have been approved by the Board and one is under preparation in the financial, environment, education and rural sectors, for total commitments of US$210 million. The graph above 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 included 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. Since 2004, the Bank's quick-disbursing assistance has taken the form of development policy lending through PRSCs, which have been developed in tandem with the Joint Review/Performance Assessment Framework process referred to above. The first two PRSCs were presented to the Board in July 2004 and in September 2005; they were valued at US$60 million and US$120 million respectively.

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 (US$71 million—FY99) supports the implementation of the National Education Strategy, whose objectives are the promotion of sustained improvements in the quality of Mozambique's labor force, and greater gender and regional equity in economic opportunities. The Higher Education Project (US$60 million—FY02) supports the entire higher education system, including both public and private institutions of higher education. The Technical and Vocational Education and Training project (US$30 million —FY06) is the first operation in the tertiary and vocational education area.

8. In **health**, the Health Sector Recovery Project (US$98.7 million—FY96, closed in 2003) supported the government's broad Health Sector Recovery Program, especially by reducing infant and child mortality. The HIV/AIDS Project (US$55 million—FY03) assists the government in carrying out its National Strategic Plan to Combat STDs and HIV/AIDS. The HIV/AIDS Treatment Acceleration Project (US$21 million—FY04) assists the Government in scaling up ongoing HIV/AIDS treatment initiatives using a combination of public/private/NGO partnerships to serve vulnerable groups. A new health operation is under preparation for FY07.

9. In the area of **transport and infrastructure**, the Bank has three active projects. The Railways and Ports Restructuring Project (US$100 million—FY00) aims at increasing the operating efficiency of the three major port-rail systems in Mozambique. The Roads and

Bridges Project (US$162 million—FY02) aims at improving road infrastructure, sector policies, and management, and the Beira Railway Project (US$110 million—FY05) aims to improve the cost-effectiveness and efficiency for freight and passenger rail transport in the Zambezi Valley and beyond. The second phase of the Roads and Bridges project is under preparation for FY07

10. In the **water** sector, one project - the National Water Development Project I (NWDP I) (US$36 million—FY98) closed on October 31, the National Water Development Project II (NWDP II) (US$75 million plus US$15 supplemental—FY99, 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 private sector management of water services in five major cities.

11. Another important part of the Bank's portfolio focuses on strengthening the investment climate and encouraging **private sector** participation. The current Bank CAS has been prepared jointly with the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA). IDA currently has one operation, the Enterprise Development Project (US$26 million—FY00, scheduled to close in FY06) which aims at broadening the base of private participation in the Mozambican economy. The Mineral Resource Management Capacity Building Project (US$18 million—FY01) seeks to increase institutional capacity in the sector, and alleviate poverty. The Communications Sector Reform Project (US$14.9 million—FY02) seeks to increase private sector participation in the postal, air transport, and telecommunications sectors.

12. As regards **public sector reform**, the Public Sector Project (US25.6 million—FY03) seeks to upgrade the quality of public services, reduce red tape, and improve access to public services. The Municipal Development Project (US$33.6 million—FY01) aims to strengthen the institutional capacity of municipal government and pilot a municipal grant mechanism to finance investment. Finally, the Decentralized Planning Financing Project (US$42 million—FY04) supports improvements to the institutional capacity of district administrations. The **Financial Sector** Technical Assistance project (US$10.5 million—FY06) supports implementation of the recommendations of the Financial Sector Assessment Program jointly conducted with the Fund in 2003.

13. The Bank is also involved in **agriculture**, **energy, and the environment.** The Agricultural Sector Public Expenditure Program (US$30 million—FY99), which will close at the end of 2005, is a sectorwide 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—FY94), which closed in 2003, supported pre-investment in the Pande-Gas Project and provided capacity building to the government for negotiation of megaprojects. This operation supported capacity and technical assistance for negotiation and implementation of the Southern Africa Gas project, a pipeline financed by SASOL of South Africa with equity participation of IFC

and guarantee coverage of MIGA (US$30 million—FY04. The Energy Reform and Access Project (US$40.2 million—FY04), which supports reform of the power sector, in particular the separation of distribution, transmission, and generation functions, aims at increasing the number of electricity connections, solar energy distributors, and seeks to provide a more efficient service. The World Bank Group is also supporting sustainable use of natural resources with two operations in environment: the Coastal and Marine Biodiversity Management Project (US$9.7 million—FY00), which pilots an integrated approach to achieving sustainable development, focusing on two main coastal areas, and the second credit of a Transfrontier Conservation Areas and Tourism project (US$20 million plus US$10 million in a Global Environment Facility grant—FY06). A Market-led Smallholder Development project of US$30 million is planned for the end of FY06.

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

- Improving the Investment Climate. Economic and sector work completed over the past two fiscal years included a strategy for rural growth and income creation and a country economic memorandum on sustainable growth and poverty reduction, which also analyzed the sources of growth. Technical assistance is currently being provided in procurement reform, mining and on commercial debt reduction. A PSIA on labor market and a PSIA on land are planned for preparation in FY06–FY07, together with a study on regional growth poles.

- Expanding Service Delivery. Work completed has involved a country status report on health; a technical assistance on health budget management; a report on the status of the health Millennium Development Goals; a Poverty and Social Impact Assessment (PSIA) on primary school fees; an assessment on labor markets and technical education; a study on private sector competitiveness; a study on local service delivery; and a report on water resource management. Ongoing and planned studies include a poverty assessment, a rural strategy, a country environmental and social assessment.

- Building Capacity and Accountability Investing in People. Work completed includes a country procurement assessment report, a legal and judicial assessment, an institutional governance review including a survey on corruption, a public expenditure review and ongoing technical assistance on public expenditure management.

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) PSIA; (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 for this reform. Under the Fund's leadership, a group of 10 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 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, 2004 and 2005 and the staff 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 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.

- **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 FY06 with a focus on Land, and a fourth one in FY07 on Labor Market.

- **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 Mozambique's 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. Between 2006 and 2007, disbursements under World Bank investment projects are expected to reach around US$125 million on average a year.

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

	1999	2000	2001	2002	2003	2004	2005
			Actual			Est.	Est.
I. Project Credit Disbursements	79.4	97.5	51.6	85.2	89.4	140.6	169.8
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	7.5	7.70
Agricultural Sec. PEP (2/99)	0.5	0.9	4.2	3.8	3.9	3.9	3.8
General Education (2/99)	1.0	0.5	1.2	6.9	14.7	19	159
Railway and Port Restructuring (10/99)	0.0	1.9	3.6	22.3	8.2	22.6	10
National Water II (6/99)	0.0	1.4	2.8	4.4	5.1	9.1	22.7
Enterprise Development (01/00)	0.0	2.3	3.0	2.9	3.4	4.5	4.6
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	3.7	1.6
Newest operations							
Municipal Development (7/01)	0.0	0.0	0.3	4.3	4.6	3.6	6.4
Roads and Bridges I (7/01)	0.0	0.0	0.0	4.3	0.5	39.1	44.6
Communications (11/01)	0.0	0.0	0.0	1.2	2.8	1.8	2.0
Mineral Resources Project (3/01)	0.0	0.0	0.2	1.4	4.1	5.5	3.2
Higher Education Project 1 (3/02)	0.0	0.0	0.0	3.4	9.2	10.0	14.2
HIV/AIDS (3/03)	0.0	0.0	0.0	0.0	2.7	2.3	10
Public Sector Reform (3/03)	0.0	0.0	0.0	0.0	1.2	1.5	1.5
Energy Reform and Access Project (8/03)	0.0	0.0	0.0	0.0	0.0	1.6	5.4
Decentralization Planning (11/03)	...	...	...	...	...	4.9	4.5
Beira Railway (10/04)						0	7.5
Treatment Acceleration Program (6/04)						0	4.3
II. Adjustment operations	150.0	0.0	0.0	63.5	70.7	60.0	60
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	...	...	...	...	...	...	60

Source: World Bank

[1] Date of Board approval in brackets.
[2] Closed
[3] Grant

Mozambique: Statistical Issues

1. An STA mission visited Maputo in May 2005 to update the data module of the Report on the Observance of Standards and Codes (ROSC) prepared in June 2002. The mission noted that significant effort has been made to address the shortcomings identified by the 2002 ROSC mission, a clear indication of the increased awareness at all levels of the importance of compiling and disseminating statistics that follow international standards and good practices. The improvements in the institutional environment and the increased allocation of resources for the compilation of national accounts, balance of payments, and more recently, government finance statistics address important weaknesses in the prerequisites for the quality of the statistics. The methodological soundness, accuracy, and reliability of the macroeconomic statistics are starting to show improvements as a result of these actions.

2. However, the overall quality of macroeconomic statistics still hinders policy formulation and monitoring of economic development. Moreover, despite the increase in budget resources allocated to the compilation of official statistics, continued high reliance on external funding raises concerns about the sustainability of the National Institute of Statistics (INE) programs.

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). Metadata are posted on the IMF's Data Standards Bulletin Board (DSBB) website, and on the INE's website. In August 2004, the INE's webpage was replaced by a portal with search capabilities that substantially improved the accessibility to available data and metadata.

National accounts

4. The national accounts are prepared by the INE. Since 1991, revised series have been compiled in accordance with the *1993 System of National Accounts* (*1993 SNA*). The INE compiles and disseminates (i) annual GDP at current and constant (1996) prices by activity; (ii) annual GDP by expenditure items at current and constant prices; and (iii) annual value added components at current prices by activity. Work is well underway to compile the new benchmark year (2003) with new and improved data sources and methodology. The INE has launched a new household income and expenditure survey and new economic censuses leading to a new business registry. Furthermore, the INE is compiling more comprehensive and timely foreign trade data based on improved classification systems. The new national accounts framework will also include compilation of quarterly estimates expected to start being disseminated by September 2006. The STA real sector advisor to the Lusophone African Countries has been stationed in Maputo since October 2002.

Prices and labor market

5. A new consumer price index (CPI) for Maputo based on weights derived from the 2002-03 household survey was released in February 2006. The previous series

consistently available since 1998 was widely criticized for narrowly focusing on a few basic food staples with relatively volatile prices and, therefore, subject to large swings. A national index obtained by integrating the indices for Maputo, Beira, and Nampula was released in April 2006. The IMF is providing technical assistance in price statistics in the context of the GDDS Regional Project for Lusophone African Countries.

6. There are insufficient sectoral labor market and employment data, and, where available, they have limited coverage. A one-year labor market survey, undertaken by INE in collaboration with the Labor Ministry, was launched in October 2004 covering the whole country. The first data are due shortly.

7. An STA mission that visited Mozambique in September 2004 prepared a work plan for the implementation of the *Monetary and Financial Statistics Manual* (*MFSM*) and the development of an integrated database to meet the needs of the Bank of Mozambique, AFR, and STA. The mission noted progress achieved in the information technology system, and in the periodicity and timeliness of the data compiled. However, the mission found that the chart of accounts of the Bank of Mozambique was inadequate to obtain a proper sectorization of the institutional units and it did not distinguish between local and foreign-currency-denominated accounts. The mission recommended improving the classification and valuation of some financial instruments, and expanding the coverage of the survey on other depository corporations by including the credit cooperatives. The new standardized forms for reporting monetary statistics to STA were derived during the mission and are now being tested to replace the existing forms. The analytical framework for compiling monetary statistics has been aligned with internationally accepted practices and the data are derived exclusively from accounting records.

External sector statistics

8. With assistance from STA technical assistance missions, the Bank of Mozambique (BM) has made significant progress towards compiling and disseminating balance of payments (BOP) and international investment position (IIP) statistics that are fully aligned with the fifth edition of the *Balance of Payments Manual* (*BPM5*). This assistance is also being provided in the context of the GDDS regional project.

9. The BM has now an adequate institutional framework for the compilation of BOP and IIP statistics, and has implemented many of the recommendations made by the four technical assistance missions that have taken place since mid-2003. However, in order for the work on institution building to be consolidated, the Foreign Exchange Law has to be approved; training on balance of payments statistics has to be sustained; and the project to computerize the balance of payments compilation system has to be completed. The major improvements in the basic sources of data from the beginning of the project comprise (1) the distribution of the new balance of payments surveys to more than 35 enterprises, including the megaprojects; (2) program improvements by Customs to ensure the quality of external trade data; (3) improvements in the reports on foreign investment and private loans prepared by the BOM; (4) improvements in the reports on the external public debt provided by the MOF; and (5) improvements in the banks' reports on foreign currency transactions.

10. Remaining problems of particular importance include (1) the coverage and quality of the data obtained in the enterprise surveys, such as data from the other SASOL[13] projects; (2) the quality of external trade data, especially with regard to price and volume indices; (3) the coverage, time of recording, and classification of the data on foreign investment and private loans; (4) completeness of data for the Reserves Template and their reconciliation with the reserve component of the balance of payments; and (5) compiling the IIP using the sources that are used for the balance of payments compilation.

11. The BM has started to compile partial IIP data, which were published in the *2005 Balance of Payments Statistics Yearbook*.

[13] Conglomerate of 5 enterprises from South African Coal, Oil and Gas Corporation.

Mozambique: Table of Common Indicators Required for Surveillance

(As of May 1, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality Accuracy and reliability[8]
Exchange Rates	Mar. 2005	Apr. 2006	D	W	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]							
Reserve/Base Money	Mar. 2005	Apr. 2006	M	M	M	LO, O, LO, O	LO, LO, O, O, LO
Broad Money	Mar. 2005	Apr. 2006	M	M	M		
Central Bank Balance Sheet	Mar. 2005	Apr. 2006	M	M	M		
Consolidated Balance Sheet of the Banking System	Mar. 2005	Apr.. 2006					
Interest Rates[2]	Mar. 2006	Apr. 2006	M	M	M		
Consumer Price Index	Apr. 2006	May. 2006	M	M	M	O, LO, LNO, O	LNO, LO, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]						LO, LNO, LO, O	LO, O, LO, O, LNO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government							
Stocks of Central Government and Central Government-Guaranteed Debt[5]							
External Current Account Balance	Dec. 2005	Mar. 2006	Q	I	I	LO, LNO, LO, O	LO, LNO, LO, LO, LNO
Exports and Imports of Goods and Services							
GDP/GNP	Dec. 2004	Apr. 2005	A	I	I	O, LO, O, LO	LNO, LO, LO, O, LO
Gross External Debt	Dec. 2005	Mar. 2006	A	I	I		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published in March 2003, and based on the findings of the mission that took place during June 2002 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO). No changes were proposed by the update mission of May 2005.
[8] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies. No changes were proposed by the update mission of May 2005.

MOZAMBIQUE: DEBT SUSTAINABILITY ANALYSIS

This analysis assesses the sustainability of Mozambique's external public debt.[14] *The debt sustainability analysis (DSA) was conducted jointly by the staffs of the IMF and the World Bank using the joint Bank-Fund framework for external debt sustainability analysis for low-income countries. The bilateral external debt data underlying this DSA were provided by the Mozambican authorities. The multilateral debt data provided by the authorities were reconciled with information obtained from the creditors. On the basis of this DSA, the staffs conclude that the risk of external debt distress for Mozambique is low, rising only with a substantial increase in non-concessional external borrowing.*

I. Background

1. At end-2005, Mozambique's external public and publicly guaranteed (PPG) debt stock, including arrears,[15] stood at US$4.7 billion in nominal terms. Of this total amount, slightly more than half (54 percent) was owed to multilateral creditors, 42 percent was owed to bilateral creditors, and about 4 percent was owed to commercial creditors (Table 1). However, thanks to the Multilateral Debt Relief Initiative (MDRI) the debt stock will fall significantly by end-2006, by US$1.6 billion in nominal terms, and from 25 to 12 percent of GDP in net present value (NPV) terms.

2. **In the past, Mozambique has benefited from HIPC assistance provided by multilateral and Paris Club bilateral creditors.** This assistance was provided both in the context of the Original HIPC Initiative (Completion Point in 1999) and the Enhanced HIPC Initiative (Completion Point in 2001).[16] The total amount of assistance pledged since the first Decision Point amounts to US$2,023 million in end-1998 NPV terms. Following the 2001 Completion Point, individual debt relief arrangements were reached with all multilateral creditors and most Paris Club creditors, except Portugal and Japan, which together accounted for about 20 percent of total Paris Club debt at end-2000 in NPV terms.[17] Nevertheless, the

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[14] A separate assessment of public debt that would include domestic debt was not made at this stage because domestic public debt is relatively low in Mozambique and is not expected to increase in the near future.

[15] Arrears to bilateral creditors amounted to approximately US$1 billion, and include arrears under the Paris Club Moratorium for Portugal and Japan. Arrears to commercial creditors amount to almost the entire outstanding stock of US$175 million.

[16] See "Mozambique−HIPC Debt Initiative: President's Memorandum and Recommendation and Completion Point Document" (IDA/R99–139), and "Mozambique—Enhanced HIPC Debt Initiative: President's Memorandum and Recommendation and Completion Point Document" (IDA/R2001–0150).

[17] In February 2005, Mozambique signed a technical memorandum with Portugal, in which Portugal confirmed that it would provide 100 percent debt service reduction. Subsequently, however, Portugal added a clause to this agreement which Mozambique has refused to accept, because it considers it to be not on comparable terms. The

(continued)

Mozambican authorities are hopeful that bilateral agreements with Portugal and Japan for 100 percent debt reduction can be reached in 2006.

Table 1. Mozambique: External Nominal Debt Outstanding at End-2005

Creditor	In millions of U.S. dollars	In percent
Multilateral Creditors	**2,559.0**	**54.5**
IDA	1,622.0	34.6
IMF	162.3	3.5
African Development Bank	544.2	11.6
Other Multilaterals	230.5	4.9
Bilateral Creditors 1/	**1,956.8**	**41.7**
Paris Club	812.0	17.3
Non-Paris Club	1,144.8	24.4
Commercial Creditors 1/	**175.4**	**3.7**
Total	**4,691.2**	**100.0**

Sources: Mozambican authorities; and World Bank and IMF staff estimates.

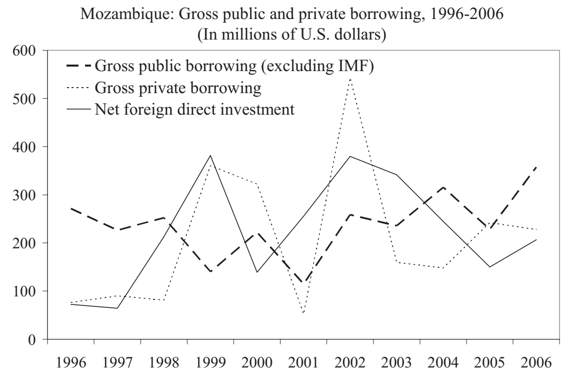
1/ Including arrears.

3. **Thus far, Mozambique has obtained very little HIPC debt relief from non-Paris Club bilateral creditors.** The only non-Paris Club bilateral creditor that has provided comparable treatment to date is Kuwait, which signed a rescheduling agreement with Mozambique in May 2002. While rescheduling agreements with India and China may also be within reach, negotiations with all other non-Paris Club creditors have reportedly stalled, despite good faith efforts from the Mozambican authorities. The two largest outstanding claims, of Algeria and Libya, amount to about half of all non-Paris Club debt (both in end-1998 NPV terms and in nominal terms at end-2005).

4. **On commercial debt, Mozambique is expected to benefit from a commercial debt buy-back operation in 2006.** This operation, which is expected to be completed by the third quarter of this year, would cover virtually all currently outstanding commercial debt in arrears,

other remaining Paris Club creditor, Japan, has also repeatedly indicated intentions for 100 percent debt reduction, but an agreement has not yet been signed due to issues with the debt reconciliation and delays of an administrative nature.

which is estimated at US$175 million at end-2005, of which around US$150 million is owed to one creditor alone.



5. **Total external debt in Mozambique has a significant private component, which is related to so-called "megaprojects."** Private external debt averaged 23 percent of the country's total external debt during the period 2001–05. This private debt is mostly the result of the fact that Mozambique has been able to attract substantial foreign private capital into so-called "megaprojects". At present, by far the most important project involves aluminum production, currently accounting for about 60 percent of exported goods, while the other two megaprojects (hydroelectric power and natural gas) account for an additional 14 percent. All three projects are expected to expand their capacity in the near future. In addition, new projects involving titanium, gold, and oil production are in the pipeline. Most of the investment into megaprojects is estimated to have been debt creating, as evidenced by the correlation between FDI inflows and private borrowing (text chart).[18]

6. **Mozambique's domestic public debt stock is relatively low by regional standards and not expected to increase significantly in the near future.** The stock of domestic public debt (treasury bills and bonds) was about 5 percent of GDP at end-2005, the majority of which is accounted for by bonds issued to recapitalize the central bank in 2005 (following losses incurred during 2004) and commercial banks related to their restructuring processes, which are now complete. Given the improved health of bank balance sheets and the medium-term fiscal framework, the level of domestic public debt should remain low and sustainable over the foreseeable future.[19]

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[18] Gross private borrowing includes gross private external borrowing by megaprojects and other private companies, including net borrowing by commercial banks from 2002, but is based on the limited information available and may not cover all private enterprises.

[19] The evolution of domestic public debt will need to be monitored, however, as the government is in the process of developing a new domestic debt management strategy with the help of technical assistance from the Bank and Fund (IDA/R2005–0220/1, "Mozambique—Financial Sector Technical Assistance Project").

II. Methodology and Key Assumptions

7. **Following the guidelines of the new LIC DSA framework, staffs have analyzed the evolution of the external public debt stock and debt service indicators for Mozambique subject to a baseline scenario and a series of stress tests.**[20] The stress tests are designed to assess a country's probability of facing debt distress in the future. In addition, staffs have considered one additional stress test, which involves a large increase in non-concessional external new borrowing by US$1 billion in 2007.[21] The motivation for this stress test is that the government is planning to enhance private sector participation in public enterprises, particularly infrastructure services (MEFP, paragraph 27), including for a number of hydroelectric projects. While the government is committed to seeking non-recourse financing for the transfer of majority ownership of the Cahora Bassa dam operating company (HCB), financing still needs to be obtained for other hydroelectric and infrastructure projects that may be implemented in the future, including possible non-concessional public borrowing.

8. **The analysis is guided by indicative, country-specific debt burden thresholds, which take into account the empirical finding that the debt levels that a low-income country can sustain increase with the quality of its policies and institutions.** The quality of policies and institutions is measured by the World Bank's 2004 Country Policy and Institutional Assessment (CPIA), according to which Mozambique ranks as a "medium performer." The indicative external debt burden thresholds for countries in this category are an NPV of debt-to-exports ratio of 150 percent, NPV of debt-to-revenue ratio of 250 percent, a NPV of debt-to-GDP ratio of 40 percent, and debt-service-to-exports and revenues ratios of 20 and 30 percent, respectively.[22]

9. **The DSA is subject to a number of important assumptions.** First, the analysis is based on a number of underlying macroeconomic assumptions, summarized in Box 1. Second, the external debt numbers underlying the analysis assume the full delivery of HIPC debt relief by all creditors in 2006, including additional bilateral debt relief (up to a 100 percent debt reduction) provided by some Paris-club creditors. This analysis also includes the completion of the commercial debt buyback operation in 2006, as described above. Third, the DSA evaluates debt dynamics before and after the delivery of additional debt relief under the recent Multilateral Debt Relief Initiative (MDRI).[23] Finally, new borrowing is assumed to be sourced predominantly from

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[20] See "Operational Framework for Debt Sustainability Assessments in Low-Income Countries—Further Considerations," March 28, 2005 (www.imf.org). The new framework introduces some methodological changes in the calculation of the NPV of debt compared to the HIPC methodology by using (a) a fixed 5 percent discount rate instead of currency specific discount rates (under HIPC), (b) WEO exchange rate projections instead of fixed exchange rates as of the end of the base year and (c) annual exports instead of a three-year average of exports as the denominator in the NPV of debt-to-exports ratio.

[21] The assumed terms of this loan are a grace period of 2 years, total maturity of 10 years, and an interest rate of 8 percent.

[22] The NPV of external debt-to-revenue ratio excludes all grants.

[23] The three creditors participating in the MDRI are the IMF, the International Development Association (IDA) of the World Bank, and the African Development Fund (AfDF). MDRI debt relief from the IMF became effective on January 5, 2006, providing stock relief on debt disbursed before end-2004 and still outstanding at end-2005. IDA

(continued)

the International Development Association (IDA) and the African Development Fund (AfDF), resulting in an average grant element of 51 percent. This assumption is based on the medium-term projections of the authorities, which were informed by consultations with donors.[24] The assumptions on grants, loans, and fiscal revenues are further described in Box 1. The share of program and project grants (excluding HIPC and MDRI assistance) is assumed to fall over time as the economy becomes less aid dependent: grants fall from almost 8 percent of GDP in 2005 to around 2 percent of GDP by 2026.

III. External Debt Sustainability

10. **Under the baseline scenario, with and without debt relief under the MDRI, the debt indicators all remain below their respective thresholds.** Under the baseline scenario after MDRI relief, which is presented in Table 2, the NPV of PPG external debt in percent of GDP is projected to rise from 12 percent in 2006 to 16½ percent by 2013, after which it slowly falls back to 12 percent by 2026. It thus remains well below the country-specific threshold of 40 percent. The NPV of PPG debt-to-exports ratio increases from 32 percent in 2006 to 50 percent by 2016—also far below the threshold of 150 percent—before falling back to about 40 percent again by 2026. The NPV of PPG debt-to revenue ratio increases somewhat initially, to a peak of almost 100 percent in 2008, which is still very low compared to the threshold of 250 percent. It then declines rapidly to 54 percent by 2026, driven in part by the assumed increase in revenue collection.

11. **The debt service indicators also remain far below their thresholds under the baseline.** As a result of the MDRI and the assumed full delivery of remaining HIPC debt relief in 2006, PPG debt service falls rapidly in 2006. The PPG debt service-to-exports ratio, which has a threshold at 20 percent, falls from 4½ percent in 2005 to 1½ percent in 2006, and rises only very slowly after that, not exceeding 3 percent by the end of the projection period. The ratio of PPG debt service to fiscal revenues falls from just above 10 percent in 2005 to 4 percent in 2006, and declines a bit further to reach an average of 3.5 percent over the next 20 years (Table 2).

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and the AfDF are expected to start providing debt relief in July 2006, provided sufficient financing commitments have been received from donors. The eligible debt covers IDA credits disbursed before end-2003 and AfDF credits disbursed before end-2004 that are still outstanding at the time of qualification.

[24] Staffs have undertaken additional analysis that shows that the results of the DSA are not sensitive to a lowering of the grant element. Stress Test A2 underscores this finding.

Box 1. Macroeconomic Assumptions 2006–26

The medium-term assumptions in the baseline scenario for 2006-2010 are consistent with the authorities' medium-term macroeconomic framework described in the government's Plano de Acção para Redução da Pobreza Absoluta II (PARPA II). The long-term assumptions are described in more detail below and are consistent with the World Bank's latest Country Economic Memorandum (CEM) for Mozambique (Report No. 32615-MZ, September 2005).

Real GDP growth is projected to remain strong at 6.5 percent per year during 2011–25, which is consistent with the 5-8 percent range projected in the CEM. Growth is thus expected to decelerate from its recent annual average of 9 percent during 2001–05, partly because of a weakening of the "catch-up" effect from the post-conflict period.

Consumer price inflation is projected to fall rapidly to 5 percent in the medium term, as oil prices and the exchange rate stabilize, and is expected to fall further to 3 percent after 2020, as it approaches trade partner inflation. The **real effective exchange rate** is expected to remain broadly unchanged, in line with the relative stability observed over the past decade.

After averaging 19 percent in the last ten years, **export growth** is projected to decelerate slowly from 10 percent in the medium term to 6.5 percent in the long term. This is driven to a large extent by megaproject exports, which are expected to remain strong at around 7.5 percent until 2015, and then to decline somewhat to 6.5 percent. Traditional (non-megaproject) exports are assumed to grow at the rate of Mozambique's trade partner import demand growth, which is projected to decelerate from at around 7 percent during 2011–2026. **Import growth** associated with megaprojects is assumed to equal the rate of megaproject export growth, assuming that the import content of megaprojects remains roughly constant on average. All other imports are assumed to grow at the rate of real GDP growth.

The current account deficit before grants is projected to narrow substantially from 15 percent of GDP during 2006–10 to 4½ percent by 2026, supported by strong export growth. The current account deficit after grants is projected to fall from 6½ percent in the medium term to 2½ percent in the long term. Consistent with this, net international reserves are projected to grow from around 4 months of imports of goods and services in the medium term to 7½ months of imports by 2018, after which they remain roughly constant at this level.

Fiscal revenues are expected to rise by around 0.5 percent of GDP per year, on account of improved tax administration and augmentation of the revenue base. Once the revenue-to-GDP ratio reaches 22 percent of GDP, which happens by 2018, it is expected to remain constant at this level, consistent with the findings from a recent mission from the IMF's Fiscal Affairs Department (FAD), which estimated potential revenue collection for Mozambique at around 22 percent of GDP. This is higher than that of most of Mozambique's neighbors, similar to Kenya, but still much lower than that of South Africa and Swaziland.

External grants to the government are projected to remain high at an average of 8 percent of GDP during the medium term, which will help finance the "second wave of reforms" needed to sustain broad-based growth and achieve the Millennium Development Goals (MDGs) by 2015. Consistent with the rise in fiscal revenues and the ensuing reduction in the financing need, grants fall gradually to 2 percent of GDP, while loans fall from 5 to 1 percent of GDP. Consistent with the historical pattern, total grants are assumed to average 66 percent of total financing during the projection period. No grant financing is assumed to come from IDA.

12. **Mozambique's debt situation proves resilient to a number of stress tests, although the risk of debt distress would rise in case of a large increase in non-concessional external commercial borrowing.** As Table 3 shows, none of the stress tests drives the debt burden indicators above the thresholds or even close to them. However, stress test B7 shows that the debt situation is potentially vulnerable to the scenario of a one-time contraction of a significant amount of non-concessional commercial debt in 2007. While still remaining below the thresholds, the debt burden indicators exhibit a sharp spike, and more than double compared to the baseline (Table 3 and Figure 1).

13. **As a robustness check, debt indicators were also calculated excluding megaproject exports.** While megaproject exports represent a significant share of total exports (72 percent in 2005), their net impact on the balance of payments is relatively small, because most transactions take place off-shore and most profits and dividends are repatriated. Since total exports may, therefore, not be a good measure of the government's capacity to repay its external debt obligations, Figure 2 assesses the NPV of debt and debt service also in terms of non-megaproject exports. Under the baseline scenario, the NPV of debt to non-megaproject exports still remains below the indicative threshold of 150 percent. It breaches the threshold only under the increased commercial debt stress test, rising temporarily to almost 200 percent, and under the most extreme stress test, which involves the contraction of new borrowing on less favorable terms. The ratio of debt service to non-megaproject exports still remains below the 20-percent threshold in all cases, but comes close to this threshold under the increased commercial debt stress test.

IV. Conclusions

14. **In staffs' view, Mozambique faces a low risk of debt distress.** Mozambique's external debt levels are expected to remain well below their indicative thresholds for debt distress both under the baseline and under various stress tests. Even under the standard bound tests and a low growth scenario, Mozambique's debt indicators remain comfortably below the indicative thresholds.

15. **However, this positive assessment presumes a prudent new borrowing policy.** Given that the Mozambican government is currently planning to enhance private sector participation in public enterprises, which could possibly involve non-concessional public borrowing, staffs considered an alternative scenario under which non-concessional external commercial borrowing would increase more rapidly for illustrative purposes. Under this scenario, the debt burden indicators more than double compared to the baseline. While they still remain below their thresholds when all exports are taken into account, the ratio of the NPV of debt to exports would temporarily exceed the threshold of 200 percent if megaproject exports were to be excluded from the denominator. This shows that external debt policy has to continue to remain prudent and rely as much as possible on concessional borrowing and grants. Any future non-concessional financing of new projects will need to be considered on a case-by-case basis based on their economic return and their impact on debt sustainability.

Table 2. Mozambique: External Debt Sustainability Framework, Baseline Scenario, 2003-2026 1/
(In percent of GDP and after MDRI, unless otherwise indicated)

	Actual			Historical Average 6/	Standard Deviation 6/	Projections									
	2003	2004	2005			2006	2007	2008	2009	2010	2011	2006-11 Average	2016	2026	2012-26 Average
Total external debt (nominal) 1/															
Before MDRI	**112.2**	**95.9**	**91.3**			**64.3**	**65.9**	**63.1**	**60.0**	**56.3**	**53.3**		**42.9**	**28.1**	
After MDRI	**112.2**	**95.9**	**91.3**			**41.3**	**43.8**	**43.6**	**42.9**	**41.2**	**40.0**		**35.8**	**26.4**	
o/w public and publicly guaranteed (PPG)	83.0	73.8	70.7			22.2	25.2	27.0	28.2	28.9	29.3		28.3	19.8	
Change in external debt	-9.6	-16.3	-4.6			-50.0	2.5	-0.2	-0.7	-1.7	-1.2		-0.6	-1.0	
Identified net debt-creating flows	-15.7	-20.3	-3.8			-4.0	1.6	1.3	0.3	-2.1	-2.6		-2.1	-0.8	
Non-interest current account deficit	**6.1**	**2.7**	**6.8**	**6.6**	**2.7**	**3.5**	**5.8**	**4.8**	**3.7**	**1.0**	**1.0**		**1.2**	**2.2**	1.6
Deficit in balance of goods and services	16.8	9.4	10.6			7.4	7.9	8.2	7.6	4.5	4.1		2.8	1.8	
Exports	28.2	30.9	32.6			37.3	38.9	36.0	35.3	36.8	36.1		32.5	29.1	
Imports	45.1	40.3	43.2			44.7	46.8	44.2	42.9	41.3	40.2		35.3	30.9	
Net current transfers (negative = inflow)	-4.9	-5.5	-5.4	-5.7	1.7	-6.3	-6.2	-5.9	-5.5	-5.1	-4.7		-3.3	-1.5	-2.7
Other current account flows (negative = net inflow)	-5.8	-1.2	1.6			2.4	4.2	2.5	1.6	1.5	1.6		1.7	1.9	
Net FDI (negative = inflow)	**-7.1**	**-4.1**	**-2.3**	**-5.2**	**2.8**	**-3.0**	**-4.4**	**-3.9**	**-3.5**	**-3.0**	**-2.9**		**-2.5**	**-2.2**	-2.4
Endogenous debt dynamics 2/	**-14.6**	**-18.8**	**-8.3**			**-4.6**	**0.2**	**0.3**	**0.1**	**-0.2**	**-0.7**		**-0.9**	**-0.8**	
Contribution from nominal interest rate	3.0	2.5	2.1			2.3	2.9	3.1	2.9	2.6	1.8		1.3	0.8	
Contribution from real GDP growth	-8.2	-6.8	-6.6			-6.9	-2.8	-2.8	-2.8	-2.7	-2.4		-2.2	-1.7	
Contribution from price and exchange rate changes	-9.5	-14.5	-3.9			…	…	…	…	…	…		…	…	
Residual (3-4) 3/	**6.0**	**4.0**	**-0.8**			**-46.0**	**0.9**	**-1.4**	**-1.0**	**0.4**	**1.3**		**1.5**	**-0.2**	
o/w exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
NPV of total external debt 4/	...	...	30.7			31.1	32.6	31.5	30.3	28.3	26.9		23.6	18.4	
In percent of exports	...	...	94.2			83.4	83.9	87.5	85.6	76.8	74.7		72.7	63.1	
NPV of PPG external debt	**...**	**...**	**10.1**			**12.1**	**14.0**	**14.9**	**15.5**	**16.0**	**16.2**		**16.1**	**11.8**	
In percent of exports	...	...	31.1			32.3	35.9	41.4	44.0	43.4	45.0		49.6	40.4	
In percent of revenues	...	...	72.5			83.8	93.9	96.9	97.4	95.9	94.5		79.7	53.5	
Total debt service-to-exports ratio (in percent)	26.3	23.9	18.3			17.2	18.5	20.7	20.4	18.9	17.8		13.0	10.9	
PPG debt service															
In percent of exports	6.9	3.8	4.4			1.6	1.5	1.6	1.5	1.5	1.6		2.1	2.5	
In percent of revenues	15.2	9.3	10.3			4.0	3.9	3.6	3.4	3.3	3.4		3.4	3.3	
Total gross financing need (billions of U.S. dollars)	0.3	0.4	0.7			0.5	0.6	0.7	0.7	0.5	0.5		0.5	1.2	
Non-interest current account deficit that stabilizes debt ratio	15.8	19.0	11.4			53.5	3.3	5.0	4.4	2.7	2.2		1.9	3.2	
Key macroeconomic assumptions															
Real GDP growth (in percent)	7.9	7.5	7.7	8.0	3.1	7.9	7.0	7.0	7.0	7.0	6.5	7.1	6.5	6.5	6.5
GDP deflator in US dollar terms (change in percent)	8.4	14.8	4.2	3.3	10.1	-2.6	-1.9	3.0	3.0	3.0	2.9	1.2	2.0	1.0	1.8
Effective interest rate (percent) 5/	2.9	2.7	2.5	2.9	0.5	2.7	7.4	7.9	7.3	6.6	4.7	6.1	3.9	3.3	3.9
Growth of exports of G&S (US dollar terms, in percent)	13.8	35.1	18.4	18.6	10.7	20.3	9.3	2.0	8.2	14.7	7.5	10.3	6.9	6.7	6.9
Growth of imports of G&S (US dollar terms, in percent)	17.0	10.4	20.4	11.8	11.2	8.8	9.8	4.1	7.0	6.2	6.7	7.1	6.6	6.5	6.6
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	51.6	51.7	52.0	52.1	52.1	52.2	52.0	52.2	52.2	52.2
Memorandum item:															
Nominal GDP (billions of US dollars)	4.8	5.9	6.6			7.0	7.3	8.1	8.9	9.8	10.7		16.8	36.2	

Source: Staffs' projections and simulations.

1/ Includes both public and private sector external debt.
2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.
3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.
4/ Assumes that NPV of private sector debt is equivalent to its face value.
5/ Current-year interest payments devided by previous period debt stock.
6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

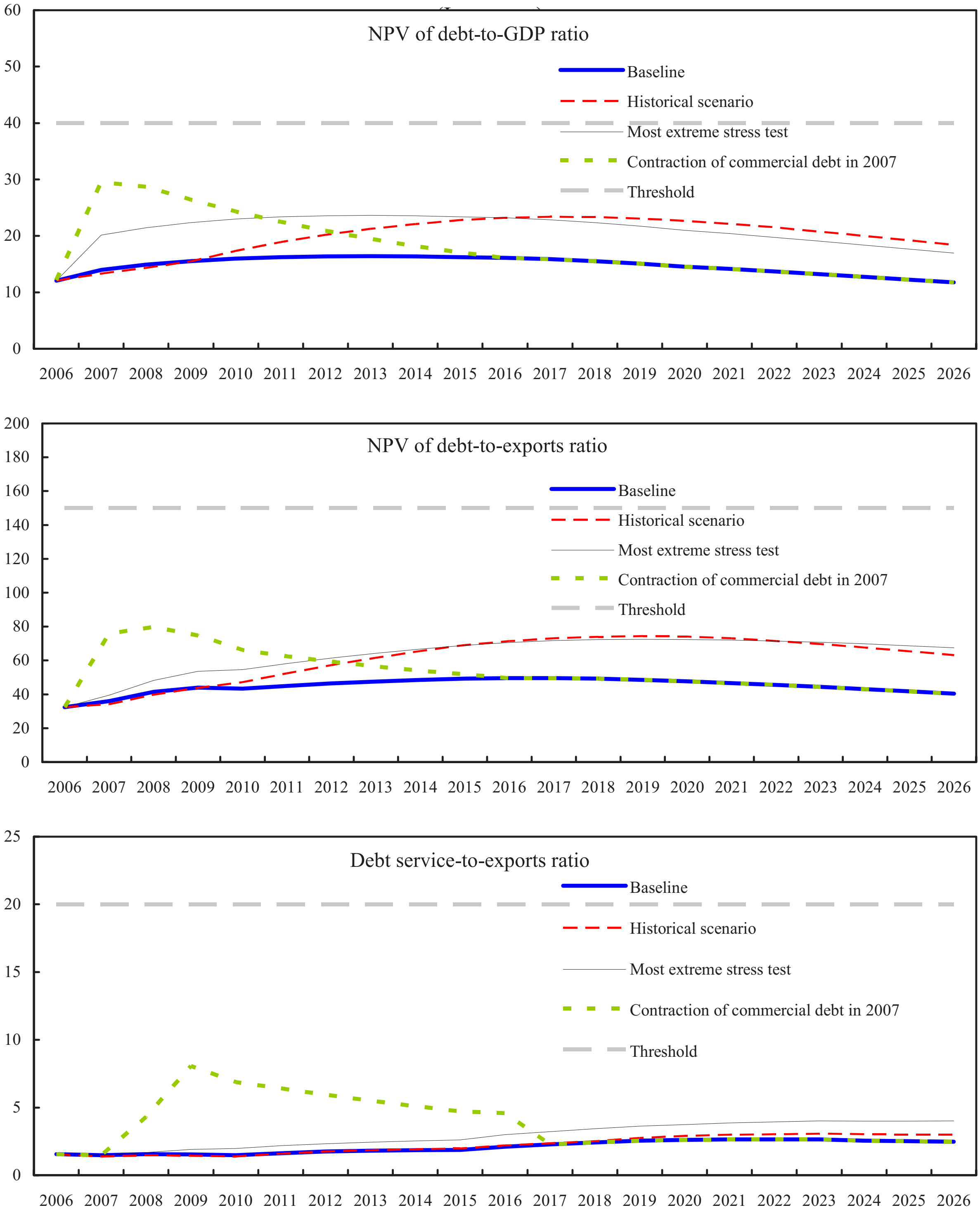
Table 3. Mozambique: Sensitivity Analyses for Key Indicators (after MDRI) of Public and Publicly Guaranteed External Debt, 2006-26
(In percent)

	Projections							
	2006	2007	2008	2009	2010	2011	**2016**	2026
NPV of debt-to-GDP ratio								
Baseline								
Before MDRI	25	26	26	25	25	24	**21**	13
After MDRI	12	14	15	16	16	16	**16**	12
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2007-26 1/	12	13	14	15	17	19	**23**	18
A2. New public sector loans on less favorable terms in 2007-26 2/	12	15	17	19	20	21	**23**	20
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	12	14	15	16	17	17	**17**	12
B2. Export value growth at historical average minus one standard deviation in 2007-08 3/	12	14	14	15	15	16	**16**	12
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	12	15	17	18	19	19	**19**	14
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 4/	12	16	18	19	19	19	**18**	13
B5. Combination of B1-B4 using one-half standard deviation shocks	12	14	14	14	15	15	**16**	12
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	12	20	21	22	23	23	**23**	17
B7. Contraction of commercial debt	12	30	29	26	24	23	**16**	12
NPV of debt-to-exports ratio								
Baseline								
Before MDRI	66	67	72	72	68	67	**64**	45
After MDRI	32	36	41	44	43	45	**50**	40
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2007-26 1/	32	34	40	44	47	52	**71**	63
A2. New public sector loans on less favorable terms in 2007-26 2/	32	39	48	54	55	58	**71**	67
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	32	36	41	44	43	45	**50**	40
B2. Export value growth at historical average minus one standard deviation in 2007-08 3/	32	37	38	41	40	42	**47**	38
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	32	36	41	44	43	45	**50**	40
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 4/	32	41	51	54	52	53	**57**	43
B5. Combination of B1-B4 using one-half standard deviation shocks	32	35	31	34	34	35	**40**	34
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	32	36	41	44	43	45	**50**	40
B7. Contraction of commercial debt	32	76	80	75	66	62	**50**	40
Debt service ratio								
Baseline								
Before MDRI	3	3	3	3	3	3	**3**	3
After MDRI	2	1	2	2	1	2	**2**	2
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2007-26 1/	2	1	1	1	1	2	**2**	3
A2. New public sector loans on less favorable terms in 2007-26 2/	2	1	2	2	2	2	**3**	4
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	2	1	2	2	1	2	**2**	2
B2. Export value growth at historical average minus one standard deviation in 2007-08 3/	2	1	2	1	1	2	**2**	2
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	2	1	2	2	1	2	**2**	2
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 4/	2	1	2	2	2	2	**2**	3
B5. Combination of B1-B4 using one-half standard deviation shocks	2	1	1	1	1	1	**2**	2
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	2	1	2	2	1	2	**2**	2
B7. Contraction of commercial debt	2	1	4	8	7	6	**5**	2
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	51	51	51	51	51	51	**51**	51

Source: Staffs' projections and simulations.

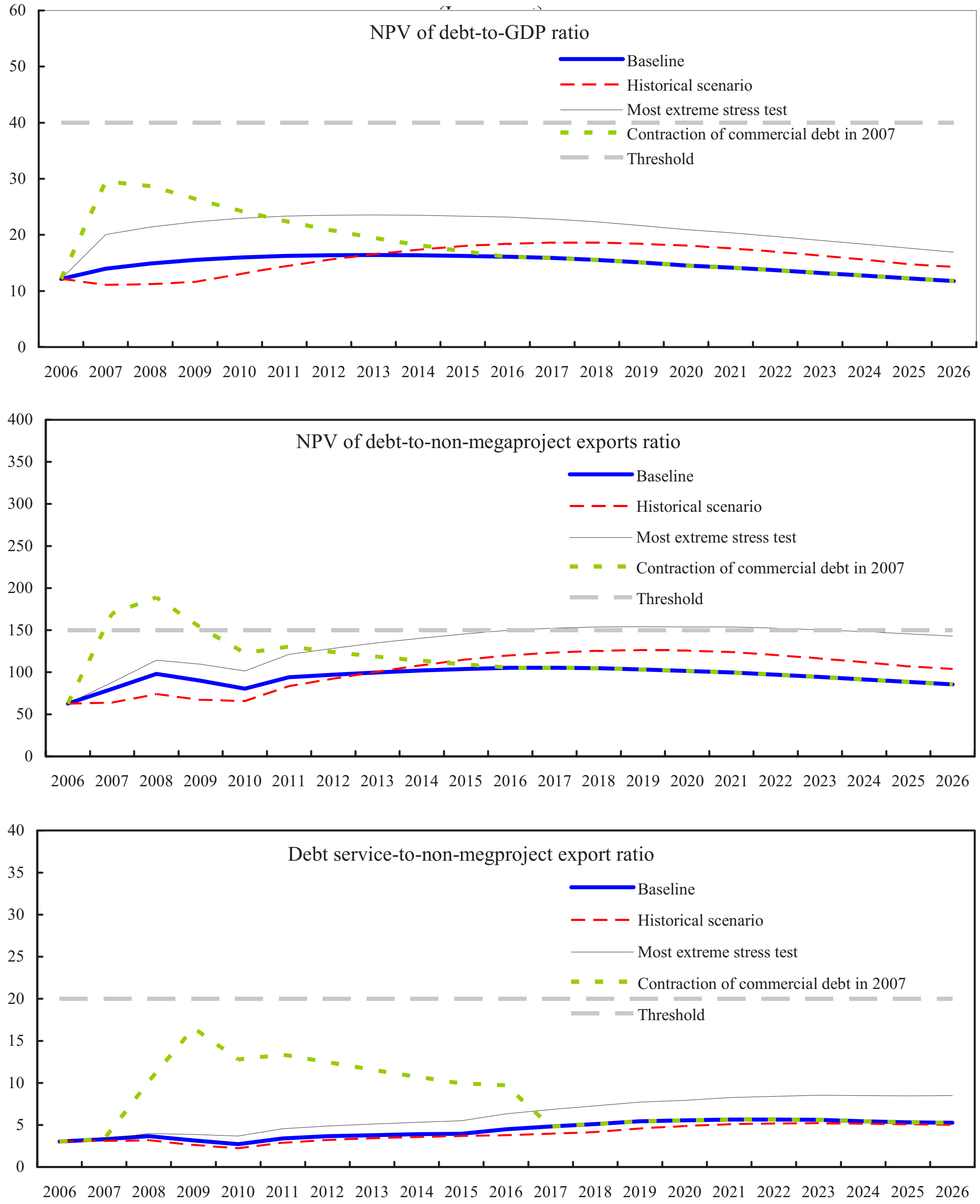
1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Figure 1. Mozambique: Indicators of Public and Publicly Guaranteed External Debt
(After MDRI)
Under Baseline and Alternative Scenarios, 2006-2026



Source: Staffs' projections and simulations.

Figure 2. Mozambique: Indicators of Public and Publicly Guaranteed External Debt
(After MDRI and excluding megaproject exports)
Under Baesline and Alternative Scenarios, 2006-2026



Source: Staffs' projections and simulations.

Statement by the IMF Staff Representative
June 19, 2006

The following information has become available since the issuance of the staff report for the fourth review of the three-year arrangement under the Poverty Reduction and Growth Facility. The thrust of the staff appraisal remains unchanged.

1. **Indicative Targets.** Preliminary information indicates that all monetary-related indicative targets for end-March 2006 have been met except for reserve money which was slightly exceeded.

2. **Structural Benchmarks.** The two structural benchmarks for end-March 2006 were implemented with a slight delay. A revised anti-corruption strategy was approved by the Council of Ministers in April 2006. A decision on the strategic option for the restructuring of PETROMOC, the state-owned petroleum distributor was taken in May 2006.

3. **Inflation.** With the start of a good harvest season, inflation is receding. Food prices account for more than 50 percent of the CPI basket. As expected, recent information at end-May shows a decline in food prices by almost 3 percent resulting in a monthly inflation rate of minus 1.1 percent and an inflation rate of 4.8 percent from January to May against 6 percent at end-April. The program inflation targets are thus within reach, albeit with some risks related to further rises in fuel prices.

4. **Fuel Prices.** Domestic fuel prices have increased in June by about 17 percent on average with kerosene and cooking oil prices increasing by 10 percent.

5. **Interest rates.** All Treasury bill auction rates are now market-determined and have increased by about 6 percentage points since the removal of interest rate caps in March 2006. This has helped reestablish positive real interest rates.

6. **Fiscal.** The Council of Ministers approved in May the Medium Term Expenditure Framework for 2006-08 (MTEF). The MTEF is a three years rolling expenditure plan that translates the PARPA II into a concrete action plan with identified sources of funding. The preparation of the MTEF was improved. The fiscal targets are consistent with the PRGF-supported program.

INTERNATIONAL MONETARY FUND

EXTERNAL RELATIONS DEPARTMENT

Press Release No. 06/134
FOR IMMEDIATE RELEASE
June 19, 2006

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Fourth Review Under the Three-Year PRGF Arrangement for Mozambique

The Executive Board of the International Monetary Fund (IMF) today completed the fourth review of Mozambique's economic performance under an SDR11.36 million (about US$16.7 million) Poverty Reduction and Growth Facility (PRGF) arrangement (see Press Release No. 04/153).

The completion of the review enables the release of 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 8.1 million (about US$11.9 million).

The Executive Board also accepted that as part of the financing assurances review that adequate safeguards remain in place for further use of Fund resources, as well a request for modification of performance criteria.

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

“Mozambique’s strong macroeconomic performance continued in 2005 and early 2006, despite exogenous shocks. Fiscal results have been commendable and all performance criteria through end-March 2006 have been met. While the macroeconomic outlook remains favorable, vigilance will be required, in light of volatile oil prices and unpredictable weather.

“Over the medium term, the main challenges are sustaining broad-based economic growth and making further inroads in alleviating poverty through the implementation of a poverty reduction strategy for 2006–09. This will entail persevering with stabilization efforts, reducing the cost of doing business, and continuing to address governance issues directly, including by further enhancements to the legal framework and strengthening the transparency of natural resource management, in line with the principles of the Extractive Industries Transparency Initiative.

“To help achieve the Millennium Development Goals (MDGs), the government should ensure that additional external financing, including Multilateral Debt Relief Initiative (MDRI) resources, are allocated to the most economically and socially productive areas in a manner that does not compromise macroeconomic stability. A costing of the programs that are targeted towards the MDGs should facilitate this allocation.

"The authorities' commitment to create sufficient fiscal space for priority investments is welcome. This will require enhanced revenue mobilization as well as reinvigorated public sector reform program and governance strategy aimed at improving public service delivery and using additional donor assistance effectively. The decentralization strategy should also be clarified and well sequenced, with appropriate checks and balances.

"The 2006 fiscal framework includes higher priority spending financed by MDRI resources from the Fund and should be accompanied by the rollout of e-SISTAFE (Financial Administration System) to ministries and other entities at the central and provincial levels to ensure a better monitoring of expenditures. Moreover, off-budget donor-funded projects should progressively be brought on budget and included in e-SISTAFE with the continued help of the donor community.

"The Bank of Mozambique's pursuit of base money targeting, in conjunction with a flexible exchange rate regime has served the country well. In this regard, the removal of the interest rate caps in the treasury bill auctions and the authorities' renewed commitment to a flexible exchange rate system are noteworthy. Supported by a public information campaign covering the entire country, the introduction of the new family of metical banknotes should protect price stability and secure the savings of the poor. Enhanced bank supervision and accounting standards should ensure financial stability and a prudent financial deepening.

"Mozambique's external debt levels will remain well below its indicative thresholds for debt distress in the foreseeable future. In that context, the authorities' commitment to financing the transfer of majority ownership of the Cahora Bassa dam operating company through non-recourse financing that does not increase the government's liabilities to commercial creditors is welcome. The authorities' are commended for their good faith negotiations to facilitate collaborative agreements with all external creditors," Mr. Kato said.

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 the 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 5½-year grace period on principal payments.

Statement by Peter Ngumbullu, Executive Director for Republic of Mozambique and Joseph Tekman Kanu, Senior Advisor to Executive Director June 19, 2006

1. On behalf of my Mozambican authorities, we thank staff for their constructive dialogue with the authorities and for the well written reports which clearly identify the challenges for macroeconomic stabilization and policy options facing the country. The authorities remain confident that the Fund and other development partners will continue to assist them to ensure that the objectives of their reform agenda are achieved. Mozambique's macroeconomic performance in 2005 continued to be strong. International reserves remained at a comfortable level, clearly reflecting continued increase in donor inflows. Program performance has been satisfactory, and all quantitative performance criteria were met while most of the real effective appreciation of the metical in 2004 was reversed during2005.

Recent Economic Developments

2. The annual average inflation rate moderated from 12.6 percent in 2004 to 6.4 percent in 2005 due to lower food prices, but the spike in domestic petroleum prices and pass-through of the exchange rate depreciation in October - November 2005 led to some acceleration in the last few months of the year. However, the economy continues to perform well in spite of these exogenous shocks, and real GDP growth remained at 7.5 percent in 2005 due largely to activities in construction, mining, communication and the transport sector, as well as contributions from the mega-projects.

3. The authorities' increased domestic revenue effort led to an increase of 1.5 percent of GDP in revenue receipts due to the buoyancy of corporate tax collections and the substantial rise in non-tax revenues, which included mega-project dividends. The better-than-programmed fiscal consolidation efforts also led to the domestic primary deficit being narrowed by nearly 2 percent of GDP in 2005. Expenditures were lower than expected due to delay in the adoption of the 2005 budget following the general election in December 2004.

4. In order to strengthen its balance sheet, the Bank of Mozambique (BM) issued securities totaling MT 1.5 trillion in June 2005 as envisaged in the program. Improvements in the prudential ratios of the banking system resulted in fall in the ratio of non-performing loans to below 5 percent. The performance criteria on net domestic assets for end-December 2005 were also met, although broad money was higher than programmed due to greater than anticipated net foreign assets and stronger growth of the economy. The required provisioning of 50 percent of commercial banks foreign currency-denominated loans to non-exporters resulted in decline in the ratio of foreign exchange loans to total loans. Overall, commercial banks are well capitalized and profitable.

5. On the structural front, notable advances were made in the area of legal reform, leading to the approval of the new Commercial Code, the Commercial Registration Code, and the Civil Procedure Code in December 2005, while commercial sections in the judicial tribunals of the city of Maputo were also established. Despite delays in implementation of

some of the envisaged reforms, the authorities remain committed to completing them and to substantially improve access to justice for all citizens.

Projected Outlook and Policies for 2006

6. The authorities' 2006 policy framework aims at continuing with the fiscal consolidation process with view to improving the achievements already made in their macroeconomic stabilization and poverty reduction efforts and ensuring strong economic growth. The transparency efforts and monitoring of the budget execution process will be strengthened. The existing multi-disciplinary committee will help to reinforce the existing coordination between the Bank of Mozambique (BM) and the Ministry of Finance (MF), with view to reduce inflation and ensure sustainable fiscal and external position. However, a major downside risk to the macroeconomic outlook is the continued rise in international oil prices and its effects on inflation dynamics and the country's trade deficit.

7. The fiscal program will continue to focus on improving revenue administration and strengthening public expenditure management (PEM) systems through further implementation of the e-SISTAFE. The authorities will continue to modernize tax administration and procedures and ensure effective direct budget execution for goods and services in the Ministries of Finance, Planning, Education, Agriculture, Health, and Public Works at the central and provincial levels by end-July 2006. The rollout of the Homoine version of software for the e-SISTAFE will help to ensure that off-budget project expenditures will be captured and executed through the Treasury Single Account (TSA) in order to improve the monitoring of all development activities. The allocation of an investment budget for each district will be followed by a gradual rollout of e-SISTAFE to all districts by end-September 2006. The authorities will continue to implement the fiscal decentralization strategy with due regard to sequencing, in particular the need to buttress local administrative capacity, procurement and financial reporting and auditing.

8. Monetary policy will largely remain unchanged and will continue to target base money in order to achieve the inflation target for 2006. All interest rates will remain market-determined. The absence of a liquidity overhang in the banking system, and the downward trend in non-food inflation are expected to help minimize inflationary risks. The authorities remain committed to a flexible exchange rate regime in order to help cushion against exogenous shocks and maintain a comfortable level of international reserves. Bank credit growth to the economy is projected to remain robust and will be supported by a rise in government savings and structural factors. A strengthening of the liquidity forecasting framework, and a deepening of debt markets and debt management will, with the help of TA, assist in avoiding an excessive level of interest rate volatility.

9. To ensure transparency of monetary policy, the authorities will, with Fund technical assistance, adopt by end-December 2006, a Long-Term Monetary Policy Strategy that will define the intermediate targets compatible with the base money operational target, design a new format for the monetary policy committee, and specify its communication policy. Efforts will be directed at strengthening and modernizing the supervisory and accounting functions of the central bank. The new organizational structure of the banking supervision department,

consistent with the Integral Strengthening Plan for Banking Supervision, will be approved by end-December 2006. The central bank will in addition, adjust its Chart of Accounts by end-September 2006 to allow for: (i) the valuation of foreign exchange gains/losses consistent with International Financial Reporting Standards (IFRS); and (ii) the preparation of BM's financial statements for 2005 in compliance with IFRS in parallel to the financial statement prepared under the current accounting standard.

10. The authorities are determined to provide sound financial system for effective working of the economy. In this regard, they intend to reinforce and expand the financial sector framework by implementing the integral plan for licensing of microfinance institutions (MFIs) and capacity building measures for the pension and insurance regulator. In addition, they will approve in early 2007, the new regulation on the assessment, classification and provisioning of credits, as well as regulation on integral risk management for credit institutions and finance companies.

11. The authorities thank the international community for the provision of debt relief under the MDRI which has greatly contributed to their efforts towards reducing poverty. As a result of the resources obtained through the MDRI, the authorities will substantially increase the share of spending on priority sectors, in particular education and health, as a ratio of GDP. They will continue to vigorously implement measures that will facilitate halving the NPV of public external debt to about 12 percent of GDP in 2006 from 25 percent in 2005, given that the joint Bank-Fund DSA shows sustainable debt dynamics susceptible to a ratcheting up of non-concessional external borrowing. In view of the above, the authorities are strongly committed to seeking concessional financing for the transfer of majority ownership of the Cahora Bassa dam operating company, Hidroelétrica de Cahora Bassa (HCB), so as not to increase the government's liabilities to commercial creditors.

Given the need for infrastructure development, we encourage donors to ensure timely disbursement of resources and to facilitate concessional lending to the authorities.

12. Although proving difficult, because of the lack of provision of comparable treatment, negotiations with some large non-Paris Club bilateral creditors in the context of the enhanced HIPC Initiative are on-going. The authorities will continue to maintain contact with these creditors, as well as with their commercial creditors, in order to reach a collaborative agreement. Given that external financing appears to have been secured, the authorities expect to undertake by mid 2006, the commercial debt buyback operation with private creditors that will be consistent with comparability of treatment.

13. As regards trade, the authorities will continue with the trade liberalization process during 2006. To buttress their commitment, they have lowered in January 2006 the maximum tariff rate applicable to SADC trading partners from 25 percent to 20 percent.

A legislative authorization draft has already been submitted to the Assembly for an extension of this measure to all trading partners. They will proceed with bilateral free trade arrangements as recommended in the Action Matrix of the Diagnostic Trade Integration Study and expect to sign a bilateral free trade agreement with Zambia this year.

14. Reforms in the exchange rate and trade system will be vigorously pursued to eliminate any further delays. The authorities will submit to the Assembly by end-September 2006, the new foreign exchange law that will form the basis for accepting the obligations under Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement.

15. More effort will be directed at improving the business environment in order to promote a diversification of exports. In addition, the authorities will continue to make progress in improving access to finance for both bank credit and outreach of micro finance institutions (MFIs), as well as extend the national electricity grid to include rural areas. They intend to pursue further measures that will ensure an increase in labor market flexibility, strengthen contract enforcement and property rights, and bridge the infrastructure gap through greater private participation and public-private partnerships.

16. The authorities are aware of the structural challenges facing the economy and given the requirements for an action-oriented approach with a high level of commitment and leadership to give a clear sense of direction in pursuing these reforms, they are committed to strengthening the decentralization process, and thereby integrate activities and institutions. The strategy to be pursued will provide clear legal, regulatory, and institutional framework for revenue raising and spending responsibilities of sub national units and monitoring of their fiscal operations. Furthermore, in order to improve payroll management and identify ghost workers, the authorities will create an integrated payroll database system as it will not be possible to reconcile the existing three databases of civil servants.

Medium-Term Macroeconomic Policy Outlook

17. The authorities' macroeconomic objectives in the medium-term are to maintain a rate of growth of about 7 percent and reduce the inflation rate through pursuit of prudent fiscal and monetary policies in the context of a flexible exchange rate system. Economic policies will be geared to promoting export-led private sector growth, while maintaining debt sustainability. The authorities will also ensure a gradual consolidation of the fiscal position, in order to increase credit to the economy and maintain a competitive exchange rate. On the basis of current net external financing projections, the domestic primary deficit is projected to decline while average revenue will increase by 0.5 percent of GDP per annum. In the event that scaling-up of external program support materializes, the authorities intend to use the available resources to finance additional expenditures on "priority" sectors to improve public expenditure management and ensure macroeconomic stability. To facilitate such a flexible approach, with the assistance of the donors they will prepare costed programs to enable achievement of the MDG targets.

18. Following the approval by the Council of Ministers in April 2006, the authorities have prepared the third annual report on the implementation of the PARPA, which together with the Five-Year Plan, have been very instrumental in the preparation of PARPA II, that covers the period 2006–09.The authorities' medium-term priorities includes reduction of absolute poverty through implementation of policies that ensure macroeconomic stability, greater private investment, and sustainable economic growth. In view of these objectives, PARPA II clearly reveals that the authorities are on track to meet the MDGs on income poverty, infant and maternal mortality, and access to safe drinking water. They will ensure

effective use of additional donor support and expand their absorptive capacity in other areas such as primary school enrollment, gender equality, and HIV/AIDS.

19. The authorities' structural reform agenda articulated in the PARPA II includes the launching of a second wave of reforms, focusing on increasing tax collection, strengthening public expenditure management and fiscal transparency, implementation of agricultural and rural development strategy, reduction in the cost of doing business, reforming of the judicial sector and ensuring a strengthening of the financial system. More emphasis will be placed on areas of promoting human capital formation, infrastructure investments, and maximizing the net contribution of natural resources and mega projects. To this end, the authorities will implement measures to strengthen transparency of natural resource management and their exploitation, while ensuring that more benefits accrue to the country from these projects.

Conclusion

20. The developments and prospects for the Mozambican economy remain favorable and the authorities have expressed strong commitment towards program implementation, especially on the underlying macroeconomic policy framework consistent with the PARPA objectives. The authorities request completion of the fourth review and financing assurances under the PRGF arrangement including modifications to the NIR and NDA performance criteria for end-June 2006 as part of the streamlining of quantitative targets. In support and strengthening of the country's objectives and policies, the authorities are also requesting disbursement of the fifth loan under the PRGF arrangement.

21. Finally, the authorities wish to thank the international community and the Fund for their continued support to Mozambique. They strongly commit themselves to ensure that the objectives of the macroeconomic stabilization program and PRGF are achieved.