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the International Development Association

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Report No. P-7043-MOZ

REPORT AND RECOMMENDATION

OF THE

MANAGING DIRECTOR

TO THE

PRESIDENT OF THE

INTERNATIONAL DEVELOPMENT ASSOCIATION

ON A

PROPOSED INTERIM FUND CREDIT

IN THE AMOUNT EQUIVALENT TO US$100 MILLION

TO

THE REPUBLIC OF MOZAMBIQUE

FOR A

THIRD ECONOMIC RECOVERY CREDIT

January 8, 1997

CURRENCY EQUIVALENTS

Currency Unit: Metical (MT)
US$1= 11,800

FISCAL YEAR

January 1 to December 31

ABBREVIATIONS AND ACRONYMS

AEF	Africa Enterprise Fund
APDF	Africa Project Development Facility
BCM	Banco Comercial de Moçambique
BIM	Banco Internacional de Moçambique
BM	Bank of Mozambique
BPD	Banco Popular de Desenvolvimento
CAS	Country Assistance Strategy
CG	Consultative Group
CFM	Caminhos de Ferro de Moçambique (national railways)
CPI	Center for Investment Promotion
CRF	Clean Report of Findings
ESAF	Extended Structural Adjustment Facility
GAPVU	Gabinete de Apoio à População Vulnerável
GDP	Gross Domestic Product
FIAS	Financial Investment Advisory Service
HIPC	Heavily Indebted Poor Countries
ICM	Instituto de Cereais de Moçambique
IDA	International Development Association
IFC	International Finance Corporation
IMF	International Monetary Fund
LAM	Linhas Aéreas de Moçambique (national airline)
MIGA	Multilateral Investment Guarantee Agency
PAU	Poverty Alleviation Unit
PSI	Pre-shipment Inspection
SERC	Second Economic Recovery Credit
UTRE	Enterprise Restructuring Technical Unit
VAT	Value-Added-Tax

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MOZAMBIQUE

THIRD ECONOMIC RECOVERY CREDIT

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This operation was prepared by a team consisting of Rocio Castro (Senior Country Economist and Task Team Leader, AFTM1); Luis de Azcarate (Adviser), Jehan Arulpragasam (Economist, AFTM1); Manuela Ferro (Economist, AFTM1); Simon Bell (Senior Economist, AFMMZ); Yash-Pal Kedia (Transport Specialist, AFTT1); Kishor Uprety (Legal Counsel, LEGAF); Maria Teresa Benito (Research Assistant, AFTM1); and Adriana Arriagada (Staff Assistant, AFTM1). Adrien Goorman (IMF, Fiscal Affairs) participated in the appraisal mission.

MOZAMBIQUE

THIRD ECONOMIC RECOVERY CREDIT

SUMMARY

Borrower: Republic of Mozambique

Executing Agency: Ministry of Planning and Finance

Amount and Terms: SDR 69.1 million (US$100 million equivalent) of an Interim Fund Credit, on standard IDA terms with 40 years maturity, including 10 years grace period.

Description: The proposed adjustment Credit would continue to support Mozambique's medium term economic reform program aimed at achieving sustained growth with poverty reduction and diminishing dependency on external aid. In particular, the proposed Credit would support measures to improve macroeconomic management, through financial and fiscal reform, and to remove impediments to a sustained supply response. Measures to improve macroeconomic management include the privatization of state banks, improved budget management, and limiting indirect subsidies to enterprises. Supply side measures include: rationalization of the tariff and indirect tax regime; cashew liberalization; and private concessioning of CFM's port and railway operations.

Benefits: The proposed operation is designed to establish a more stable macroeconomic environment, to diversify the economy and thereby release the forces of growth and poverty reduction. By addressing key obstacles to growth, the operation is expected to translate in a rapid supply response. One particular component, the liberalization of the cashew market, should have a direct poverty reduction effect by enhancing the incomes of over one million small farmers, half of which are women.

Risks: The proposed operations involves serious risks. Although improving, weak institutional capacity may slow down execution of several components of the program. The complex processes of privatizing the state banks, restructuring the railways, and reforming fiscal procedures,

are areas where delays could be experienced because of limited capacity. More importantly, there may be resistance to further economic liberalization, which at the present stage of reform touches the very core of some vested economic and political interests. These risks are mitigated by the careful design and phasing of the reforms and by the government's commitment to reform. This commitment has been visibly demonstrated over time, most notably recently, by the privatization of BCM, the largest of the two state banks, in July 1996.

Disbursements: The proposed Credit will be disbursed through the Bank of Mozambique. Disbursements will be in two tranches. The first tranche (US$50 million) will be disbursed after approval. The second tranche (US$50 million) will be released when all conditions of Second Tranche Release are satisfied, expected by the last quarter of 1997.

Project ID Number: MZ-PA-35922

REPORT AND RECOMMENDATION OF THE MANAGING DIRECTOR TO THE PRESIDENT OF THE INTERNATIONAL DEVELOPMENT ASSOCIATION (THE ASSOCIATION ACTING AS ADMINISTRATOR OF THE INTERIM TRUST FUND) TO THE REPUBLIC OF MOZAMBIQUE FOR A THIRD ECONOMIC RECOVERY CREDIT

1. I submit the following Report and Recommendation on a proposed Interim Fund Credit of SDR 69.1 million (US$100 million equivalent), on standard IDA terms, to the Republic of Mozambique, in support of its structural adjustment program.

2. The proposed Third Economic Recovery Credit is the fifth adjustment credit to Mozambique supporting the continued restructuring and recovery of the economy. Mozambique has been successfully moving from a system of rigid central planning, despite a devastating civil war, to a democratic and private sector driven economic system. Peace, along with profound structural reforms, has generated a significant growth momentum, particularly in rural areas, which is already reflected in improved social and economic indicators. Growing interest within the Southern Africa region to invest in Mozambique, especially to develop the transport corridors, offers further opportunities for growth and export earnings. The principal objective of the Credit is to continue supporting macroeconomic stabilization and to remove key impediments to sustainable growth. Main reforms include the privatization of the two state-owned banks, rationalization of the tariff and indirect tax regime, budget management reform, liberalization of the cashew market, and private concessioning of the operations of CFM (*Caminhos de Ferro de Moçambique*) -the national ports and railways.

I. THE ECONOMY

A. Background

3. After independence in 1975, Mozambique's development was stifled by rigid central planning, a fifteen year war, and the exodus of Portuguese skilled labor. By the mid 1980s, much of the economic and social infrastructure inherited from the colonial period had been destroyed, and GDP was only two thirds, and exports one-third of their post-independence peak (1980). Mozambique's external debt had reached unmanageable levels, and most of the people were living in absolute poverty. In 1986, the Government decided to abandon a socialist approach to economic development, and embarked upon a far reaching reform program towards a market economy. Progress, however, was limited both in geographic extent and in supply response, by continuation of the war.

4. The war ended in 1992 with a Peace Agreement signed by the Frelimo Government and the Renamo rebels. Following the demobilization of about 80,000 soldiers, Mozambique's first multi-party elections were held in October 1994, returning Frelimo to power. After a successful transition, the new Government is now firmly established and the democratic process is evolving well. A small new army, combining

the adversary forces of Frelimo and Renamo, has been formed; the National Assembly meets regularly; opposition parties are fully participating in the political debate.

5. The Mozambican economy has experienced **strong, though uneven, growth** since 1987, averaging 7 percent annually.[1] Main favorable factors include the presence of substantial external aid (including food aid), which permitted the maintenance of minimum levels of private consumption and financed the partial rehabilitation of basic infrastructure; economic liberalization; and the restoration of peace with the subsequent resettlement of millions of displaced persons in rural areas. This in 1993 spurred GDP growth to 19 percent. On the other hand, adverse shocks have been the loss of aid and export markets from the former Soviet Union and the drought of 1992. Growth has come mainly from small scale agriculture and the informal sector, but also to an increasing extent, from an emerging private sector gradually taking over, through privatization and new investment, the activities of the previously state-controlled economy.

6. While GDP per capita is thought to be significantly higher than the U$85 estimated in 1995, Mozambique is one of the poorest countries in the world. Reliable data are sparse, but **poverty** indicators are low even by the standards of Sub-Saharan Africa. Eighty percent of the total population lives in rural areas, two-thirds of them in absolute poverty. Rainfed subsistence agriculture leaves the rural poor vulnerable to drought and natural disasters. Moreover, the war displaced millions of rural households and destroyed much of the social services built during post-independence, including one-third of all rural health units and two thirds of the primary school network. The average daily caloric intake is just 77 percent of the daily estimated requirement, while the average for Sub-Saharan Africa is 93 percent. Chronic malnutrition is estimated to affect 30 to 40 percent of children. About 60 percent of the population lacks access to health services, and roughly three-quarters lacks access to safe water (in the rural areas less than 20 percent is served). Infant mortality (162 per thousand live births), under five mortality (283 per thousand live births), maternal mortality (1,100 per hundred thousand) and illiteracy rates are all about one-third higher than the average for sub-Saharan Africa. Meanwhile, fast population growth, of 2.7 percent per annum, creates pressing demands for the provision of social services.

7. Since it embarked upon its market-oriented economic reform program in 1987, Mozambique's **overall adjustment performance** has been reasonably good. Significant economic liberalization has taken place and a basic framework for private sector development has been established. However, the macroeconomic framework is fragile, while weak institutional and human capacity constrains the pace of structural reform across sectors. With peace, emergency assistance is being phased out, but Mozambique remains highly dependent on external aid, both to finance imports and the Government

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[1] Mozambique's real GDP levels are substantially under-estimated. Revised national accounts series for 1990-95 should be officially adopted in 1997.

budget. Moreover, with an accumulated nominal external debt, at 3.8 times GDP and 13 times exports, Mozambique faces an unsustainable debt burden over the medium term.

8. In sum, most indicators since 1987 would place Mozambique among the success stories in Africa. However, this judgment needs to be qualified in two important respects. First, to a large extent the economic record reflects recovery from extremely depressed levels rather than progress along a firmly established growth path. The restoration of peace is a unique event and the extraordinary levels of foreign aid will not last for ever, to cite two important factors. Second, while the first impact of the economic liberalization has been felt, a difficult reform agenda still lies ahead. In particular, a properly functioning financial sector, involving a number of competitive private banks, and an improved tax and expenditure management system still need to be further developed in support of the growth process.

B. Recent Economic Developments and Prospects

9. The main economic developments in 1995 and 1996, have been the continuation of growth and the deceleration of domestic inflation. To a large extent, these favorable outcomes relate to the continued reform program of the Government which was endorsed by the international aid community at the last Consultative Group (CG) meeting in April 1996. Notably, the privatization of the enterprise sector has accelerated markedly and decisive progress has been made in the financial sector with the sale of the largest state bank, *Banco Comercial de Moçambique* (BCM), in July 1996. The reform program in this period has been supported by the Bank, under the on-going Second Economic Recovery Credit (SERC), and by the Fund, under two successive Extended Structural Adjustment Facility (ESAF) arrangements. The second ESAF arrangement was approved in June 1996 to replace the previous arrangement ending in 1995, which had not been completed because some quantitative benchmarks for that year were not met.

10. Performance during the first year of the current ESAF arrangement (April 1996-March 1997) has been generally satisfactory. The main macroeconomic targets for 1996 are expected to be achieved, including an inflation rate of less than 22 percent, a GDP growth rate of at least 4 percent, and an increase of over US$70 million in net foreign assets. Money supply is expected to increase by less than programmed (20 percent), with the increase in net foreign assets being partly compensated by a decline in net domestic assets. This was consistent with a real expansion in credit based on government net repayments to the banking system programmed at around one percent of GDP. The fiscal deficit before grants is expected to decline further to around 15 percent of GDP, with expenditure cutbacks accommodating revenue shortfalls experienced throughout the year. The Fund's mid-term review mission, which focused on compliance with quantitative and structural benchmarks through September 1996, took place in late November/mid-December 1996. The staff recommendations on the mid-term review will be presented to the Board in late January. A mission to negotiate the second year of the ESAF arrangement is planned for March 1997.

11. **Growth**. Although GDP growth in 1995 was estimated at 1.5 percent, this modest performance masked highly contrasting developments: strong growth in the productive sectors (8 percent), partly off-set by a large contraction in government services due to the termination of special programs related to the peace process. Agriculture expanded by 5 percent in real terms, despite a drought which affected the south of the country. Notably, agricultural growth was led by an 18 percent increase in marketed output from the smallholder sector, reflecting the continuing positive impact of rural resettlement, on-going rehabilitation of the road network, and further trade liberalization. Manufacturing output increased by 18.5 percent in real terms, reversing a five-year decline, as the privatization of large industrial companies started to bear fruit. The construction and transport sectors also expanded rapidly.

12. GDP growth in 1996 is now expected to reach 6 percent. During the first six months of 1996, real GDP grew by 7.4 percent relative to the same period in 1995. While most sectors fared well, agriculture continued to lead growth in response to policy reform and good weather. Most significant sectoral developments have been the doubling of the volume of marketed cashew (producer prices increased by 30 percent in real terms due to both the elimination of quantitative restrictions and a reduced export tax); and a record grain harvest of 1.3 million tons, the highest in twenty years.

13. **Poverty Impact**. These developments have had a positive impact on food security and the living conditions of the poor, particularly in rural areas. Food security has improved with per capita availability from all cereals projected to be equal to or higher than any year since 1989/90, despite a drastic reduction in food aid. The estimated number of families in need of food assistance has declined from over 1 million last year to only 90,000 in 1996. Moreover, the higher marketed quantities of white maize, the local staple, have resulted in a decrease of the real retail price level since 1992. The increase in producer prices and marketed output of cashew have enhanced money incomes of over 1.5 million people in the rural family sector. At the same time, the provision of social services has also improved. Indications are that the volume of health services provided to the population expanded by 12 percent between 1993 and 1995, principally in rural areas. These services include increases in coverage of mother and child health care and vaccinations. Available data also shows that between 1991 and 1994, primary school enrollment rates among 6-10 year olds increased from 24 percent to 45 percent in the rural areas.

14. **Stabilization**. Inflation decelerated from 70 percent in 1994 to 54 percent in 1995. It slowed further to 26 percent for the twelve month period ending November 1996. The inflation target rate of 22 percent for 1996, given that the accumulated rate for the first eleven months was 15 percent, will be achieved. Lower inflation is the result of tighter monetary control, a more stable nominal exchange rate, and increases in food production. Furthermore, a newly developed consumer price index for two cities outside of Maputo indicates that the rate of inflation for these urban centers is lower than that reflected in the above figures which apply only to the Maputo area.

15. Until recently, **monetary policy** has had limited success in controlling monetary expansion. Broad money had grown above programmed levels in every year since 1987. A key factor had been the inadequate control over the two state banks, the BCM and the *Banco Popular de Desenvolvimento* (BPD), which together accounted for over 90 percent of banking activities. The difficulties worsened after the split in 1992 of Bank of Mozambique into a central and a commercial bank, the BCM. In the absence of a well developed financial system, monetary policy has relied on direct control instruments, including, since 1994, bank-by-bank ceilings on net domestic assets. Although in 1994 money growth decelerated to an annual rate of 58 percent from 79 percent the previous year, it was still above program. Monetary policy weakened during the second half of 1995, as a financial deterioration of the two state banks led to excessive overdrafts with the central bank. The existence of large foreign currency deposits, coupled with a sharp depreciation of the metical and reserve requirements only on domestic deposits, also contributed to money growth which reached 55 percent. The turning point occurred early in 1996 when the central bank managed to better control base money, i.e., forcing the state banks to repay a significant portion of their overdrafts. Broad money increased by 9.7 percent in the January-September period, below program, and inflation came down. The privatization of BCM (completed) and of BPD (underway), together with strengthened banking supervision and monetary controls, are expected to enhance the effectiveness of monetary policy.

16. In the face of weakening revenue collection, **fiscal adjustment** has relied primarily on expenditure reduction in the recent period. Revenues as a percentage of GDP have declined from 20 percent in 1993 to around 18 percent in subsequent years, largely as a result of poor customs administration and increasing duty exemptions. In 1995, the fiscal deficit before grants fell to 20 percent of GDP from 30 percent in 1994, mainly reflecting the end of externally financed expenditures linked to the peace process. However, unplanned expenditure cuts were also made to accommodate lower than programmed counterpart funds from external grants and lower customs revenues. Expenditure reduction has been mainly absorbed by cuts in the recurrent budget for defense, but it has also affected the development budget by constraining local contributions to externally financed projects. Revenue shortfalls continued during January-September 1996 because of delays in implementing customs reform. However, these were once again offset by expenditure cutbacks, and the target of government net repayment to the banking system for this period was observed. Despite the tight fiscal situation, the Government is making efforts to protect priority expenditures in the social sectors. In 1995, recurrent expenditures in health and education were increased in real terms by 15 and 21 percent, respectively, to compensate for a decline experienced the previous year, but real expenditure levels in these sectors are expected to have decreased slightly in 1996.

17. **External balances** closely mirror the fiscal situation. In 1995, the current account deficit before grants narrowed by 14 percent of GDP, mainly because of reduced imports from externally-financed special programs. There was also a 21 percent growth in exports of goods and services, reflecting strong international transport earnings. A real

depreciation of the metical also contributed to narrowing the current account deficit. During January-September 1996, merchandise exports rose by 35 percent, compared to the same period the previous year, reflecting a good agricultural crop and favorable export prices. Notably, raw cashew exports reached US$30 million compared to U$5.6 million a year earlier, and processed cashew and cotton increased by 117 and 40 percent, respectively. Despite strong export performance, the current account deficit widened in 1996 because of higher import growth associated with increased investment activity. However, higher than expected capital inflows strengthened the overall balance of payments relative to 1995. As a result, the nominal exchange rate remained fairly stable in the course of 1996 and the spread between the parallel and the official market exchange rate narrowed to less than 3 percent.

18. Mozambique negotiated a rescheduling agreement with its Paris Club creditors on November 21, 1996. The agreement involves a three-year flow rescheduling on Naples terms with a debt reduction of 67 percent in net present value terms covering about US$664 million of debt and arrears (see para. 44).

II. THE ADJUSTMENT PROGRAM

19. Mozambique's medium and long term goal is to create conditions for poverty reducing growth, while lowering the country's dependence on external aid. To build on the progress made so far and on the new opportunities opened by peace, the Government recognizes that there is an urgent need to accelerate the pace of adjustment to foster private-sector growth, including direct foreign investment, especially in high potential sectors such as small-holder agriculture, transport, and energy. At the same time, the Government sees the need to rationalize the role of the state and to strike a careful balance between the country's enormous reconstruction needs and its absorptive capacity, while maximizing the impact of diminishing levels of external aid.

20. In support of the Government's adjustment program, the Bank has extended four adjustment credits to Mozambique since 1987. The Rehabilitation Credit (FY88) focused on reducing macroeconomic imbalances, price, and exchange rate distortions. The follow-up Rehabilitation Credit (FY90) sought to improve the allocation of sectoral expenditures, and to begin trade reform and enterprise rehabilitation. The Economic Recovery Credit (F92) focused on the foreign exchange market and on setting the regulatory framework for privatization and financial sector reform. The Second Recovery Credit (FY94), which is still on-going, emphasizes banking and enterprise reforms. Cumulatively, these credits have provided support to the implementation of the government's reform program in key areas: price decontrols; liberalization of the foreign exchange market; budgetary reallocations toward the social sectors; and most importantly, privatization of enterprises and structural reform of the financial sector. These are the building blocks for the continuation of the reforms.

21. Important lessons are drawn from past operations. As adjustment moves from outright liberalization to reforms requiring increased institutional capacity, the pace of

structural reform is increasingly constrained by Mozambique's weak human resource base both within the public and the private sectors. Since institutional reforms are now at the heart of some of the structural reforms being implemented, e.g., in the financial and fiscal systems, there is a need to remain cautious as to what can be achieved in a short period of time. In addition, resistance to reforms from vested economic and political interests is strong.

A. Macroeconomic Management

22. Stabilization remains a central objective. Inflation is still high; large fiscal and external imbalances imply levels of foreign assistance which are neither assured nor desirable; and the stock of external debt is unsustainable and will necessitate special treatment. The task facing the Government is unusually difficult because improved short term fiscal and monetary management, as well as better resource mobilization and allocation, requires profound structural reforms in both the financial and fiscal areas. This particular complexity explains, in part, some of delays and slippage observed in the past. With the building blocks already in place and the experience acquired, the Government has now a better handle on these problems.

23. **Financial Sector Reform and Monetary Policy**. Over the past two years, Mozambique's financial system has made important progress in transforming itself from an oligopolistic, government-dominated structure into a more diversified and competitive system better equipped to intermediate savings in support of the enterprise sector. The banking system in 1987 consisted of two state banks, the Bank of Mozambique (BM -- a combination of central and commercial bank), the BPD, and a small private bank. In 1992, the split of BM into the central bank and a commercial bank (BCM), revealed substantial losses (equivalent to 12 percent of GDP) in BCM's balance sheet. Immediate privatization was ruled out at the time because of the bank's extremely poor financial situation and the fact that it represented virtually the entire banking system. Instead, the Government opted for a restructuring strategy which included transferring losses from the state banks' balance sheets to internal collection units and write-offs, the cessation of lending to non-performing borrowers, appointing external management advisers, and privatizing and restructuring the largest non-performing borrowers. In March 1995, faced with limited progress in banking reform, the Government announced its decision to accelerate the privatization of both state banks. Because of weak management and the imminent prospect of privatization itself, the financial situation of the state banks deteriorated so much by the second half of the year (half of the loan portfolio of both banks was non-performing) that there were doubts as to whether a qualified buyer could be found for these banks.

24. Following a complex process, the BCM was sold on July 26, 1996 to a private consortium (the sole bidder) led by the Mello Group (from Portugal), and including Zimbabwean banking interests. The process of privatizing BPD, the second largest state-owned bank, is currently underway with a Sales Advisor having been appointed in August 1996 and procedures to bring the bank to the point of sale to be concluded in

early 1997. In the past two years the private segment of the financial sector has been transformed. Shareholdings have changed in some of the existing banks to include South African interests; a new, dynamic, Portuguese bank has entered the market and is increasing its capital base and offering innovative banking services; a credit cooperative bank has been established by Mozambican businessmen; and a leasing company, providing both long term deposit and long term lending facilities started operations in 1996. This process of change is likely to continue as several other Portuguese and South African banks have indicated strong interest in entering the Mozambican market.

25. The expansion, diversification and privatization of the banking sector has made improved banking supervision an urgent necessity. The central bank therefore, with assistance from IDA and various donors, is strengthening its supervision function and is closely monitoring the commercial banks' lending portfolios, exposure limits, overdraft, rediscount and refinancing facilities and foreign exchange operations. On-site supervision is being supported by expert technical assistance, while off-site supervision is being improved under a World Bank pilot project in Africa to assist in the management of banking risks. Under the off-site program, financial institutions are being provided management information tools to review their own risk exposures in conjunction with the oversight of the central bank.

26. The central bank has decided to phase in indirect control instruments more gradually than originally planned. Therefore, **monetary policy** will continue to rely primarily on bank-by-bank ceilings until the transition to a fully operational, diversified banking sector has been achieved. Major steps in this direction are the privatization of the two state banks and the arrival of new, private banks. At the same time, the central bank has begun to use some indirect instruments by applying reserve requirements, both on domestic and foreign exchange deposits, introducing penalties on reserve shortfalls and systematically targeting and monitoring the evolution of base money.

27. The Government intends to maintain a floating **exchange rate** system, given Mozambique's vulnerable foreign reserve position. A market based foreign exchange system has been in place since April 1992, when the various foreign exchange windows - including donor import support funds -were essentially unified. The system has worked well and the differential between the official and parallel market rates has narrowed to around 5 percent, following the relaxation of restrictions on invisible transactions in 1995. In order to increase the depth of the foreign exchange market, the government has established an inter-bank dealer market and will eliminate export surrender requirements.

28. **Fiscal Policy**. With a budget equivalent to 40 percent of GDP, two thirds of which is financed by external aid, inadequate expenditure allocation and control systems, and an overall deficit before grants of around 20 percent of GDP, the task of fiscal adjustment is indeed daunting. The Government's objective is to drastically reduce the fiscal deficit before grants over the medium term and to reduce dependency on external support. The thrust of the strategy lies in revenue enhancement and expenditure

rationalization measures, both of which require complex institutional change. Therefore, achieving fiscal sustainability will be a long and difficult undertaking.

29. **Revenue** enhancing measures are essential since continuing fiscal adjustment through expenditure reduction will quickly become counterproductive as it undermines priority social and economic programs. The improvement of customs administration is central to the revenue effort and is also needed to improve the incentive regime. To that effect, the Government has signed a new contract with a preshipment inspection (PSI) company and has appointed a private company (Crown Agents) to manage and modernize customs for a period of three years. A new tariff structure has been announced, while preparations continue for the introduction of a Value-Added-Tax (VAT) by mid-1998. Specific taxes (i.e., on diesel) and rents on state owned housing will be raised to increase revenue. Collection of counterpart funds from aid will be improved by limiting exemptions and ensuring payment of counterpart funds (from import support) and of on-lent funds (from project aid-financing) by the enterprise sector.

30. There is little scope for **expenditure** reduction in the medium term. Military spending has already been trimmed, the civil service is not considered large, and government salaries are very low. In addition, debt service obligations will place increasing demands on the budget. As a result, the share of non-interest current expenditure is expected to fall by 3 percentage points of GDP over the next five years. At the same time, there is a need to rehabilitate and invest in roads, agriculture, health and education, which will inevitably result in additional recurrent expenditures for operation and maintenance. Progress has been made through the introduction of a three-year rolling investment program since 1989, but the execution of externally grant-financed investments is not fully reflected in the budgetary accounts. In order to improve the allocation and use of internal and external resources available for the public sector, there is a need to fully integrate these operations in the budget cycle. To achieve this goal, the Government has recently launched a *Fiscal Management Review* process with the assistance of the Bank and other donors. This exercise should lead to better and more transparent planning and accounting within a medium-term expenditure framework. Such a framework would provide the backdrop for the development of sector investment programs in key sectors such as agriculture and education, in addition to those already adopted in the health and roads sectors.

B. Privatization and Enterprise Reform

31. The **privatization** program has accelerated markedly in the past two years. Notably, of 32 sales of large enterprises, 26 occurred over this period. Including small and medium enterprises, over 700 enterprises, out of approximately 1,000, have been privatized. The private sector now commands well over two-thirds of industrial output compared with less than a third in 1990, and industrial recovery is taking place. Notably, a recent joint review of the impact of privatization has revealed a five-fold increase in output for all those firms under the responsibility of UTRE (the Government unit charged with the privatization of large firms) within one year of being privatized. Particular

emphasis has been placed on those public sector companies that are the largest debtors to the banking system. Of the 14 largest non-performing enterprises identified in mid-1994 under the SERC, five have already been sold, three are at the point of sale, and four are in the process of being privatized. With respect to the remaining two, bid documents are being prepared for private/public joint ventures, with a majority private sector share, for CFM's operations. As to Agricom, the marketing board, its debt has been written-off and its role in agricultural marketing drastically reduced. The Government plans to complete the privatization program by the end of 1997, including the sale of another 30 large enterprises. The impact study mentioned above has, however, also highlighted some problems in connection with bid evaluations, labor retrenchment and the assumption of pension liabilities by the new owners. The Government is undertaking changes to the program to address these problems.

32. The performance of several large state companies, primarily transport and utilities, which in 1991 were scheduled for restructuring as **public enterprises** rather than outright privatization, needs to be more effectively addressed. These companies cause indirect fiscal pressures through implicit subsidization (i.e., tax exemptions, subsidized credit, nonpayment of inputs) which threaten stabilization, while high tariffs and low quality service derived from their monopoly position are detrimental to growth. In general terms, the strategy to contend with these public enterprises involves (i) **liberalization** with a view to eliminating barriers to entry and to promoting increased competition (e.g., in aviation (some secondary routes), coastal shipping, port handling, petroleum distribution, agricultural marketing) so as to lower costs and improve efficiency; (ii) measures to impose a **hard budget** constraint for them to operate on commercial terms without access to explicit or implicit subsidization; and (iii) **enterprise restructuring**, including through privatization (aviation, coastal shipping, petroleum distribution) and increased private sector participation (railways and ports, port handling, water).

C. Private Sector Development

33. The development of the private sector is at the center of Mozambique's economic strategy. In addition to establishing a stable macroeconomic framework, and continuing privatization, financial sector and customs reforms, the Government will continue to take measures to improve and simplify the **legal and regulatory framework**. Following the recommendations of a Private Sector Development Conference held in Maputo in July 1995, the investment code was revised and simplified in August 1995. A "road map" study, recently undertaken in collaboration with the International Finance Corporation (IFC) and the Financial Investment Advisory Service (FIAS), will help define priority actions to further simplify licensing and investment procedures and to remove other impediments to business. The role of the Center for Promotion of Investment (CPI) will be modified so that the Center acts solely as an investment promotion and facilitation agency and not as an approval agency. A follow-up private sector conference to assess progress made on the agenda established the previous year was held in mid-June 1996, and another conference is planned for mid-1997.

34. With the objective of fostering exports, strengthening the capacity of domestic industries to compete against imports, and expanding the revenue base, the Government plans to further simplify and rationalize the **tariff and indirect tax system**. In 1991, the tariff regime was restructured and substantially simplified. The number of duty rates was reduced from thirty four to five, and the disparity between rates was narrowed (with a minimum duty rate of 10 percent and a maximum of 40 percent, including a general customs handling fee of 5 percent). However, uneven collection of domestic and import taxes resulting from weak customs, together with the existence of a wide array of exemptions, has resulted in an erratic structure of effective protection (including negative protection for some domestic industries). At the same time, the lack of effective exemption and drawback regimes for exporters has impaired their capacity to compete in international markets. This situation has been exacerbated by high and cascading indirect taxes, including a broad based consumption tax and a general turnover tax. As part of an on-going effort to address these problems, the Government has initiated a comprehensive customs reform program and, earlier this year, limited exemption provisions for miners and for "emergency" imports. To more fully address these anomalies, the government has adopted a reform package to reduce customs duties, especially for materials and capital goods; and further reduce customs duty exemptions. A Value-Added-Tax will be introduced by mid-1998 to replace the existing turnover tax.

35. **Small-scale agriculture** is targeted in the medium-term as the sector with highest potential for poverty alleviation and economic growth. The cessation of war and subsequent resettlement of refugees and internally displaced populations in rural areas have led to a remarkable output recovery which needs to be sustained. Further liberalization of prices and trade will improve incentives for farmers. While the markets for most crops were liberalized prior to 1995, that of **cashew**, traditionally Mozambique's strongest export crop, remained subject to price and trade distortions in the interest of protecting domestic cashew processing industry and some traders. As a result, for several years about one million cashew-producing small farmers were paid only one-third of the border price. In 1995, the Government, in a bold move and against strong resistance from the processing industry, removed all quantitative restrictions on raw nut exports, reduced the export tax from an effective rate of 40 to 20 percent, and undertook to phase out the export tax by the year 2000. The favorable impact on cashew production, as noted earlier, has been dramatic. In December 1996, the export tax was reduced to 14 percent. The Government also plans to eliminate the system of **minimum pricing** still applied on a few key cash and food crops (e.g., cashew, maize, beans, groundnuts, tobacco, sunflower, copra, rice) by 1998. Minimum prices have been inhibiting price flexibility by acting as panterritorial administrative (maximum) prices, often to the detriment of producers.

36. To promote private sector participation and competition in **rural marketing**, the Government plans to simplify licensing requirements on retailers and wholesalers (currently entailing payment of a fee, presentation of police records, bank documents demonstrating minimum balances, and submission of an annual health certificate) which impede entry into trading. Private sector participation in marketing and liberalized

producer pricing will also be promoted, in particular, by ensuring that the state cereals marketing board, *Instituto de Cereais de Moçambique* (ICM), operates only on commercial terms and without recourse to implicit or explicit subsidization.

37. An overall agricultural policy framework, as well as a medium term **investment program** for the sector, which will integrate all major Government and donor activities, is currently under preparation.

D. Human Resource Development and Poverty Reduction

38. As elsewhere in Africa, increased access to **health services and education** are critical components of a poverty-reducing growth strategy. An integrated sector program launched this year, the Health Sector Recovery Program (1996-2000), targets an increase in health coverage from 40 percent of the population currently to 60 percent by the year 2000. The program concentrates on improving the quality and coverage of services by rehabilitating and expanding the existing network of first-level facilities and rural hospitals, rehabilitating provincial and central hospitals, ensuring stable provision of medical supplies, and adequate maintenance of health facilities. The program will also train health workers and improve incentives for health sector personnel. The Government's strategy also places priority on expanding and improving primary education, especially in rural areas. An integrated education sector program that ensures strategic prioritization of activities, as well as balanced and sustainable expenditure levels within the sector, is in the planning stages. The program aims at improving the quality of education through teacher training, lower student:teacher ratios, expanded infrastructure, and a greater availability of teaching materials. With respect to secondary education, the focus will be on physical rehabilitation, on curricular improvements, and on the establishment of a professional, independent examinations system.

39. Given the extent of **poverty**, the Government's poverty alleviation strategy hinges on (i) generating faster economy-wide growth through macroeconomic stabilization and private sector development; (ii) promoting a poverty-reducing pattern of growth through support for smallholder agriculture and expansion of social services and infrastructure; (iii) developing human resources through the increased provision and quality of basic health care and primary education; and (iv) improving safety nets aimed at assisting the poorest and most vulnerable populations.

40. The Government's Poverty Alleviation Unit (PAU), established to better integrate and prioritize poverty issues in the national planning process and to strengthen the database and analytical capacity for poverty analysis and policy-making, formulated the Poverty Alleviation Strategy in 1995. PAU has completed a rural poverty profile in 1996, and an urban poverty profile is to be undertaken. A national poverty assessment and Poverty Action Plan will be prepared by 1998. The Action Plan will include a reform of existing social safety nets so as to improve targeting and cost-effectiveness. Currently the social safety nets include a School Lunch Program, a Social Fund for Medicine, an Infant Food Supplement Program, and the cash transfer scheme by the *Gabinete de Apoio*

à População Vulnerável (GAPVU) covering 80,000 households in 13 urban districts. The replacement of emergency food aid distribution in rural areas by a rural disaster safety net and/or a rural nutrition safety net will also be considered under the Poverty Action Plan.

E. Public Administration and Governance

41. Mozambique's public service suffers from a shortage of skilled staff as well as low incentives, weak management, inadequate information systems, and heavily centralized decision-making structures. The Government plans to undertake a public sector reform program that will address the retraining of civil servants and decompression of their salaries, as well as the decentralization of administrative functions and elimination of noncore activities and duplication. The timetable for the program is under discussion. To strengthen governance, the Government plans to establish an independent Higher Authority to combat corruption and to submit to the National Assembly a Code of Ethics for public officials. The procedural and legislative mechanisms for effective implementation of the code of ethics and actions by the Authority are also being established.

F. Environment

42. During 1996-98, the Government will implement national management programs for key natural resources such as water, wildlife, fisheries, and timber that clarify user rights for each of them. Of particular importance will be the development of a strategy to manage water resources, including international rivers, with high priority on the implementation of appropriate water-demand control measures; a coastal zone management program, currently under preparation; and a policy on stumpage fees, still to be developed. In 1996, umbrella environmental legislation will be submitted to the National Assembly and environmental impact assessments will be required under the investment law. Implementation of the National Environmental Management Program (NEMP) strategy will be challenging, and will require substantial institutional development, including the strengthening of capacity at the Ministry for Coordination of Environment Affairs itself.

G. Medium Term Prospects and External Financing Requirements

43. The macroeconomic objectives for 1996-98 are to (i) achieve an average annual growth of non-energy GDP of 5 percent (ii) reduce inflation to below 10 percent by end-1998; and (iii) increase gross international reserves to the equivalent of four months of imports and non-factor services. With peace, Mozambique has a good chance to sustain rapid growth rates over the medium term, provided key reforms are implemented, and external assistance remains available to meet the country's financing requirements. Agriculture and transport are expected to lead growth and export earnings in the near future. Construction and services should also fare well, while industrial recovery, so far concentrated on a few privatized firms, is expected to spread to other privatized industries as well. Importantly, the energy sector should add another 2-4 percentage points to GDP growth from 1997 onward, reflecting the impact of large investment in gas (Pande) and

the resumption of electricity exports (Cahora Bassa). Even with increased export growth, however, Mozambique will require large amounts of external financing in the future, including substantial debt relief.

44. At the end of 1995, Mozambique's **external debt** was estimated at US$5.6 billion (US$4.6 billion in net present value), 3.8 times the GDP or 13 times exports of goods and services. With over two-thirds of debt owed to bilateral creditors (half to non-Paris Club members), Mozambique faces essentially a bilateral debt problem. The share of multilateral debt service, however, is projected at around 10 percent of exports of goods and services over the next three to five years (as payments to the African Development Bank and the IMF become due), with IDA debt service accounting for around 2 percent of exports of goods and services. Even if a stock-of-debt operation were provided under Naples Terms on all its bilateral debt, the net present value of Mozambique's debt to exports ratio will remain above 250 percent within the next ten years. Mozambique is one of the countries identified as eligible under the proposed "heavily indebted, poor countries" (HIPC) initiative. Technical work is underway and preliminary recommendations are expected to be presented to the Bank and Fund Boards during the first half of 1997.

45. Aid partners indicated their willingness to meet Mozambique's financing needs for 1996 and endorsed its policy reforms at the CG meeting last April. **External financing requirements** in 1996 amounted to $1billion, including US$310 million of debt relief on debt service obligations. External financing was estimated at US$700 million, consisting of US$271 million in grants, US$333 million in official borrowing, US$60 million in commercial borrowing (for Cahora Bassa), and US$75 million in direct foreign investment. IDA's disbursements were estimated at US$216 million. The next CG meeting is scheduled for May 1997.

III. THE PROPOSED CREDIT

46. The proposed Credit is the fifth IDA adjustment credit for Mozambique. The credit has been designed to support the Government's reform agenda as outlined in the Policy Framework Paper for 1996-98 and the Bank's Country Assistance Strategy for Mozambique (CAS) approved by the Board in November, 1995. The broad elements of the strategy include (i) the restoration of a stable macroeconomic framework and removal of cross-cutting impediments to growth, through private sector development, improved public sector management, and increased attention to environment and gender; (ii) human resource development; and (iii) promotion of high growth potential sectors.

47. Within this broad strategic agenda, the proposed Credit will focus on structural and policy reforms aimed at strengthening aggregate **demand management** on the one hand, and at facilitating a rapid and sustainable **supply response**, on the other. The first area concerns key aspects of fiscal, monetary, and financial management. The second concentrates on key elements of the business environment and on two sub-sectors of high growth potential in agriculture and transport. This operation builds on the reforms

undertaken since the first recovery credit and supported by the IMF and other donors. With respect to the previous adjustment operation, the on-going Second Economic Recovery Credit (SERC), the proposed operation will complete some key reforms in the financial sector, most importantly, the privatization of state-owned banks. Similarly, the private concessioning of key CFM (the national ports and railways) operations is part of the overall restructuring strategy designed under the SERC. Intensive economic and sector work has provided the foundations for the other components of this operation, particularly regarding the cashew subsector and the tariff and indirect tax reforms. The agenda of this credit is, in short, designed in the spirit of bringing to conclusion key elements of reform discussed at the last CG meeting.

A. Macroeconomic Stabilization

48. Evidence of an acceptable macroeconomic framework will be a Condition of Second Tranche Release. Satisfactory progress under the ESAF program will be one of the key indicators for this. Periodic assessments of the macroeconomic position will be made and will involve, as in the past, continuous consultations with the Fund staff.

49. **Financial Sector Reform**. Building on the financial sector reform begun under the SERC, the **privatization of the two state-owned banks** has been at the center of the dialogue between the Bank and the Government and more concretely a Government priority since March 1995. The privatization of BCM, as noted earlier, was completed in July 1996. Already the newly privatized bank is reviewing and rationalizing its activities and is being closely monitored by the banking supervision department of the central bank. The consolidation of the bank is likely to lead to a reduction in both the relative and absolute size of the bank which will, in conjunction with the new bank entry which has recently taken place, assist in the development of a more competitive banking system.

50. Within BPD, the process of privatization, being undertaken with Bank assistance, is underway. Although BPD is a much smaller bank than BCM, it has a similar number of staff and four times the branch network, but only one third of operations. Consequently, the bank has very high overhead costs which, in combination with very poor loan recovery, have resulted in large losses. In light of this, and given the low level of interest shown by potential buyers in the case of BCM, the Government has adopted a more flexible approach for the sale of BPD. This could involve selling the bank as an entire entity, which the Government prefers but which is the least likely outcome; selling some parts of the bank; splitting the bank and selling different branches to different buyers; and so on. These options, and the Government's preferred option are reflected in the Sales Prospectus, which has already been issued. It is the Government's intention that the bank will be sold by end-March 1997. Any unsold portion of BPD, which may turn out to be the whole bank if there is no qualified buyer, will be converted into a "savings only" organization, mobilizing savings for wholesale application in Government guaranteed instruments only. No credit services will be provided by such an institution. This will mean that, by the second quarter of 1997, Mozambique will have a completely

privately-owned commercial banking system. As a Condition of Second Tranche Release, BPD will have ceased to operate as a state-owned lending institution.

51. As stated in the Letter of Development Policy, the continuation of measures to strengthen banking supervision will include, first, an update of the Banking Law, to be submitted to Parliament in 1997, to reflect modern bank supervisory practices and, second, a number of specific measures to enhance supervisory capacity by increasing the number of supervisors, intensifying their training, improving management information systems, and implementing a regular program of off-site and on-site supervision of all financial institutions. This program will be supported by expert technical assistance from foreign financial institutions and will be closely monitored by IDA, particularly as regards the regularity and quality of the supervision reports.

52. **Budget Management Reform**. With the objective of ensuring medium-term sustainability and efficiency of public expenditures, the proposed operation also supports the implementation of a multi-year Fiscal Reform Strategy, being prepared under a highly collaborative exercise between Government, the Bank and other donors. The main thrust of this medium-term fiscal strategy is reflected in the Letter of Development Policy. The reform strategy would cover five initial components: (i) *Budgetary framework*: a new Budget Law (*Lei de Enquadramento Orçamental*), presented to the National Assembly in November 1996, defines more fully the scope, design and procedures for the preparation and approval of the budget and introduces a more refined economic and functional classification of budgetary items; (ii) *Accounting system*: to implement the law, a new accounting system, including computerization and greater coverage, has been designed and will be gradually introduced on the basis of a specific timetable extending over the next five years; (iii) *Aid management and public investment*: a work program has been defined to further strengthen the link between the annual budget and the three-year rolling investment plan, to improve the coverage of both budget and plan by including all externally grant financed projects, and to establish a better link between budgeting and execution with the objective of achieving a realistic balance between resources and expenditures; (iv) *Human resources:* fiscal management improvements will only be possible with the development of capacity and an increase in the government's ability to retain qualified staff; a concrete program for this is being formulated; and (v) *Fiscal governance:* the National Assembly is already involved in the budgetary debate and the 1997 Budget has been presented to them; in addition, the strategy will seek to strengthen inspectorate and auditing institutions which are currently dormant or seriously understaffed. This is partly supported by IDA under the Capacity Building: Public Sector and Legal Institutions Development Project.

53. **Indirect Subsidies to Enterprises**. Although direct subsidies to enterprises have been reduced from 12 percent of GDP in 1986 to less than 1 percent, implicit subsidies can still be provided in the form of non-payment of taxes, counterpart funds and on-lent funds (from donor project financing), as well as credits at below market rates (rediscounting, refinancing). A full estimate of the subsidies involved for all public enterprises is impossible to ascertain. Investigation of some of the major enterprises

indicates, however, that the amounts involved constitute a substantial drain. Imposing limits, and in due course putting an end to these practices, is therefore an important task to control quasi-fiscal pressures. To that effect, the Government has undertaken to give or renew firm instructions to the Treasury (dealing with counterpart funds and on-lent funds) and to the central bank (rediscounting, refinancing) to strengthen their accounting, monitoring and sanctioning systems. Specifically, regarding the management of on-lent funds the Government will: (i) based on an inventory of all outstanding agreements as of end 1995, estimate actual disbursements and debt service due; and (ii) issue guidelines for setting the terms and conditions for the on-lending of funds to commercial borrowers. Verification that these measures are effective will be a Condition of Second Tranche Release.

B. Supply Response Measures

54. **Tariff and Indirect Tax Rationalization**. The proposed Credit supports the Government's tariff and indirect tax reform efforts aimed at removing existing impediments to domestic supply recovery. Given Mozambique's regional setting, successfully reforming the taxation of goods and services will involve progressively shifting reliance for revenue generation from a narrow international trade base toward a broad domestic consumption base. Thus, over the medium term, the most efficient system will be one with few and low duty rates, no exemptions, a very selective excise tax, and a Value Added Tax (VAT). With this objective in mind, the Government has adopted a reform package (effective from January 1997) as detailed in the Letter of Development Policy, which both simplifies and rationalizes the trade regime. The most important features of this reform package include the reduction of nominal duty rates on inputs (2.5-5 percent) and capital goods (5 percent), substantial narrowing of the scope of the consumption tax, and significant reduction of exemptions.

55. While the new duty structure represents an improvement over the previous regime, a number of qualifications apply. First, the dispersion between the lowest and highest rate (35 percent) is still high, and therefore effective protection on final products will remain high. Second, some misclassification of products remains, also intended to protect domestic industry: cereal flours, fabrics and unprocessed milk products which are clearly intermediate goods have been classified under the top 35 percent duty rate. Third, the elimination of exemptions has not been as extensive as it could have been. In particular, NGOs and political parties remain exempt. Over the medium term, however, the Government intends to lower the top rate, subject to the revenue constraint, and to further limit remaining exemptions. Issues of misclassification will be kept under review in the context of the on-going dialogue with the Bank. The Government also intends to review the export regime in order to put exporters as close a possible to a free trade status, e.g., through an effective system of bonded warehouses for garment exports. Most importantly, the Government plans to introduce of a VAT system. The details of the VAT are still being designed, but it is understood that the tax will apply at the retail level, though on a limited base to start with, and will involve a single rate (with zero rates for

some items including exports). The submission by Government of the VAT law to Parliament will be a Condition of Second Tranche Release.

56. The improved trade regime will be as good as implementation capacity will permit. This latter component is being supported by the Bank under a separate project and is being closely monitored by the Fund also. A critical element of customs reform is the full reconciliation of taxes due and paid. This in turn involves systematically comparing information contained in the Clean Report of Findings (CRF, prepared by the PSI company) and the import declaration (documentation used to clear the good from Customs- *despachos*). Currently, the PSI company is not performing the reconciliation adequately because Customs is only submitting secondary information instead of the original import declaration itself. Therefore, evidence that a full reconciliation system has been established and has been carried out for at least six months will be a Condition of Second Tranche Release.

57. It is expected that the trade and customs reform package, including the reorganization of customs, will at least be revenue neutral. Indeed, given the currently very low yield of import taxes (barely 10 percent of the value of imports), the reform of customs administration alone should very significantly enhance revenue collection in the short run.

58. **Cashew Liberalization**. Cashew is one of Mozambique's key export crops with high potential for growth, poverty reduction and foreign exchange earnings. Following the recent elimination of quantitative restrictions and reduction of the export tax, production nearly doubled in the 1995/96 season to about 60,000 tons, the highest level since 1981 but still well below short term potential (80-90,000 tons). With a view to ensuring a sustainable and rapid recovery of the cashew sector, the proposed credit will support adherence to the Government's declared policy to phase out the export tax on raw nuts by the year 2000. Therefore, the export tax will be further reduced from the current level of 14 percent in the intervening years. The impact of cashew liberalization on farmers, with special focus on women, will be periodically reviewed under this operation. To that effect, a monitoring survey has been designed with Bank assistance. The Government commitment to the phasing out of the export tax and to completing a baseline survey and analyzing its results is reflected in the Letter of Development Policy. At the same time, the cashew working group (Government, processors and traders) is to carry out a study that will focus on complementary measures to make the industry more competitive. Should the study bring any new salient facts to bear with regard to the export tax, the phasing out schedule will be reviewed.

59. **CFM Restructuring**. Mozambique's transit corridors hold a high potential for growth and foreign exchange earnings. In the pre-independence period, the transit corridors generated about US$ 75 million (US$300 million at current prices) in foreign exchange receipts or about half of total exports of goods and services. The war, the establishment of alternative routes in South Africa, and inefficiency in the ports and railway system led to a steady decline in traffic levels; foreign exchange earnings

bottomed out at US$35 million in 1986. Subsequently, substantial rehabilitation financed by external aid, and improved security have contributed to raise export earnings to US$70 million per year. Growing interest within the region, especially from South Africa, to develop the Maputo Corridor, opens tremendous opportunities for Mozambique to regain market share close to pre-independence times. However, poor management by *Caminhos de Ferro de Moçambique* (CFM), the public enterprise running the national ports and railways, remains a severe constraint on improved services and financial performance.

60. The Government has prepared a comprehensive restructuring strategy for CFM with the objective of increasing transport foreign exchange earnings by two to three times from current levels. The proposed Credit supports the implementation of the Government's restructuring strategy for CFM. A Private Concessioning Plan (PCP) for CFM has been completed and tenders for the granting of concessions of the port services, remaining port terminals, and railway lines of CFM-South will be issued by the end of March 1997. Completion of the evaluation of these bids will be a Condition of Second Tranche Release.

C. Poverty Impact

61. In a general manner, the proposed Credit will contribute to poverty reduction by improving the prospects for accelerating overall economic growth. The program under the Credit should also lead to improving the Government's resource position through the reform of tariff and tax components. In addition, the fiscal management reform component will lead to better management of these resources and therefore, will make possible the continued increase in the allocation of resources to health and education, especially in rural areas. One particular component, the liberalization of the cashew, market should have --indeed already has had-- a direct poverty reduction effect as it will enhance the earnings of 1.5 million small farmers, half of which are women active in this traditional activity.

D. Environmental Impact

62. The proposed Credit does not have a direct environmental impact. However, it is expected that the continued liberalization of the cashew market, supported under the Credit, will lead to increased rehabilitation and plantation of cashew nut trees in the medium to long term. This is expected to have a positive environmental impact. The new incentive climate for cashew production should reverse current practices of burning cashew trees around farmers' compounds because of their poor monetary return. In addition, the planting of cashew trees in arid areas can be expected to stabilize the top soil and reduce erosion. With rapid overall economic growth and associated urban development, industrialization, and increased tourism (in particular, along the coastal zones), the potential for environmental damage will be greater. To address these risks, the Government has created the Ministry for Coordination of Environmental Affairs and has developed a National Environmental Management Program, focusing on the protection of natural resources (see para. 42).

E. Specific Credit Agreements

63. A summary of the specific conditions for second tranche release is presented below. Several important actions supported by this operation, most notably perhaps the privatization of BCM, have already been taken. In effect, most of the second tranche conditions are a follow up of those actions. These are summarized below.

Conditions of Second Tranche Release

(a) The Government will have suspended the operations of BPD as a state-owned lending institution (para. 50).

(b) The Government will have estimated the level of disbursements and debt service due under on-lent agreements to enterprises and will have issued guidelines for setting the terms and conditions for the on-lending of funds to commercial borrowers (para. 53).

(c) The VAT law will have been submitted to Parliament (para. 55).

(d) A complete reconciliation of import taxes due and paid, based on the appropriate documentation, will have been established and effectively carried out for at least six months (para. 56).

(e) The evaluation of the bids for granting of concessions of the port services, remaining port terminals, and railway lines of CFM- South will have been completed (para. 60).

F. Implementation and Monitoring Arrangements

64. The proposed credit of US$100 million will assist in meeting Mozambique's financing requirements during 1997 and the first half of 1998. The credit will be disbursed through Bank of Mozambique. Disbursements will be in two tranches. The first tranche in the amount of US$50 million will be released at effectiveness during the first quarter of 1997; and the remaining US$50 million will be released when the conditions of Second Tranche are satisfied, most likely during the last quarter of 1997. Simplified disbursement procedures under adjustment credits will apply. The Borrower will open an account at the Central Bank. Upon notification of tranche release for each tranche, proceeds of the credit will be deposited by IDA in this account at the request of the Borrower. If after deposit in this account, the proceeds of the credit are used for ineligible purposes, i.e., to finance imports included in the negative list or originating from an ineligible country under the Interim Fund Credit Agreement, IDA will require the Borrower, either to (a) return the amount for use for eligible purposes; or (b) refund the amount directly to IDA, in which case IDA will cancel an equivalent undisbursed amount of the credit. The Ministry of Planning and Finance will be responsible for the overall implementation and monitoring of the credit.

65. In addition to monitoring macroeconomic indicators, in conjunction with the Fund, monitorable performance indicators to be followed during supervision of the operation would include (i) evolution of customs and sales tax revenues; (ii) transport foreign exchange earnings; (ii) cashew exports; (iv) cashew producer prices; (iv) evolution of on-lent funds, counterpart funds, refinancing and rediscount facilities; and (v) budget coverage of grant project financing. Occasional surveys of selected enterprises will also be undertaken to monitor the impact of tax and tariff reforms.

66. The proposed operation will support a system to monitor the *poverty-gender impact of cashew liberalization.* To this end, household survey data will be systematically collected and analyzed on producer incentives, production, and farmers' incomes. Since most rural households are headed by women, the monitoring system will be specifically designed to analyze the *gender impact* of cashew liberalization. This *gender-impact* monitoring system is to be financed by bilateral grants from SPA partners. Mozambique is one of three gender pilot countries under the SPA.

G. Benefits and Risks

67. This operation is part of a continuing process of reform designed to establish a stable macroeconomic environment, diversify the economy through enhanced domestic and foreign investment, and thereby release the forces of growth and poverty reduction. By addressing key obstacles to growth, the operation is expected to translate into a rapid supply response in the short term. In addition, a successfully implemented operation would assist in sustaining growth through the proper functioning of a private sector-led financial sector, a fiscal system capable of raising revenue with minimum distortions and able to allocate expenditure along established priorities, a reasonably supportive business environment and an efficient transport network. An indicated above, the cashew reform component of the Credit will have a significant, direct poverty reduction impact.

68. The proposed operation involves serious risks. As in the past, and despite Mozambique having made substantial progress in institutional and managerial capacity, there are still many areas of weak capacity which may hinder or slow down execution of several components of the program. The complex process of privatizing the banks and increasing private sector participation in the railways, as well as reforming fiscal procedures, are areas where expectations may be somewhat above implementation capacity. The more serious risk, however, stems from resistance to further economic liberalization, which at the present stage of reform touches the very core of economic and vested interests and powerful political and social groups. There may also be some opposition from formal sector urban dwellers who are bound to suffer from layoffs and the general restraint on wages during the stabilization period. At the same time, the actual and potential beneficiaries of the liberalization policies, namely small farmers, are, as usual, without much political clout. As expected, there is also strong resistance from the stakeholders in several key institutions to be privatized, liquidated or reformed, for example, the two commercial state banks, the customs administration, the railways and the cashewnut processing industry. These entities see themselves as losers in the process

and have little inclination to look at the possible benefits, not only for the country but for themselves, over the long haul. With media statements and sheer inertia, these vested interests continue to manifest their opposition to reform.

69. The Government has accomplished a great deal in mitigating associated risks by informing the public in general about the need and benefits of reform, and by actively seeking consultation with the private sector and other stakeholders as to the scope and pace of policy changes. The Government has also carefully designed reforms and implemented them in a phased manner whenever possible. Examples of this approach are the liberalization of the cashew market and the reform of the tariff and indirect tax regime. In addition, the Government has undertaken ex-post evaluations of major reform programs, notably the privatization of industrial enterprises, and has disseminated its results. Success of the overall reform program will ultimately depend on the Government's firmly holding its course within the boundaries permitted by a still very young democratic society. In this respect, the Government has reiterated its firm determination.

IV. BANK OPERATIONS

70. Mozambique's portfolio consists of 21 operations, including 20 investment projects, totaling US$1,017 million. Of this total, US$605 million, or 59 percent, is undisbursed. In order to improve implementation of the on-going investment portfolio, the Bank and the Government have engaged in a comprehensive portfolio review aimed at restructuring, retro-fitting or canceling projects to bring the portfolio in line with Government priorities in the post-war period. An action plan for this is expected to be completed by March 1997.

71. In line with the strategic priorities outlined in the CAS (see para. 46), IDA's future lending will focus on macroeconomic stabilization, social services, capacity building and infrastructure. Given absorptive capacity constraints and the need to improve portfolio implementation there will be a maximum of two new investment projects added to the portfolio each year. Structural adjustment credits, accounting for 45 percent of future lending, are planned for every eighteen months to two years and will focus on a few key reform elements. Investment lending in the immediate future will focus on supporting sector investment programs in water, agriculture, and education. Lending will be complemented by selective sector work and non-lending outputs. Economic and Sector Work will focus on both immediate and longer-term policy concerns. Examples of recent work include the study on Impediments to Industrial Recovery (FY95), and the on-going Fiscal Management Review. Resources are also being directed toward "non-lending high-impact tasks". These are technical assistance, policy advice, and analytical tasks which do not necessarily result in formal Bank reports, but which are assisting the Government in priority areas. Examples of this type of work recently completed or underway include: support in the preparation of an Education Master Plan, support in undertaking a Participatory Poverty Assessment, advice on land

policy, environmental management and transit corridor policy, support for energy sector strategy, and support for Government/ Private sector seminars.

72. In response to increased investor interest, **IFC** has broadened its activities in Mozambique and has placed a representative of the Africa Enterprise Fund (AEF) - the IFC's Small Projects Facility- at the Bank's Resident Mission. The Corporation's portfolio currently holds two flagship privatizations: LOMACO, a major agricultural company (FY87), and the Polana Hotel (FY92), with a total commitment amounting to US$4.5 million. In FY96, IFC approved five projects with total financing of US$30 million. This included *Cimentos de Moçambique*, the largest privatization so far in Mozambique; *Mocita*, a cashew nut processing plant; and *Banco Internacional de Moçambique* (BIM). Two other small projects were approved through AEF in the fishing and agriculture sectors. The Africa Project Development Facility (APDF), an advisory arm for small and medium-size enterprise, has completed three projects helping local entrepreneurs propose feasibility studies and raise financing. FIAS and IFC continue to work with the Government to revise investment legislation. Mozambique joined the Multilateral Investment Guarantee Agency (**MIGA**) in late 1994. Interest in MIGA coverage has been expressed by various investors resulting in ten applications for MIGA guarantees to date in tourism, agriculture, and natural resources. MIGA's Investment Marketing Services continues to promote mining investment throughout Africa, including Mozambique.

V. COLLABORATION WITH THE IMF

73. The Bank and the IMF will continue to work in close cooperation in Mozambique, launching joint missions to review progress in structural adjustment and to develop, in collaboration with the Government, Policy Framework Papers. The Policy Framework Paper for 1996-98, was approved by the Fund and the Bank management in April 1996. The proposed operation will run in parallel with new IMF Extended Structural Adjustment Facility (ESAF) approved in June 1996. The IMF and the Bank are also collaborating in assisting the Government in other areas as well, such as financial sector reform, strengthening statistical capacity, tax and customs reform, and debt sustainability analysis under the HIPC initiative. The next Policy Framework Paper is expected to be completed by April 1997.

VI. RECOMMENDATION

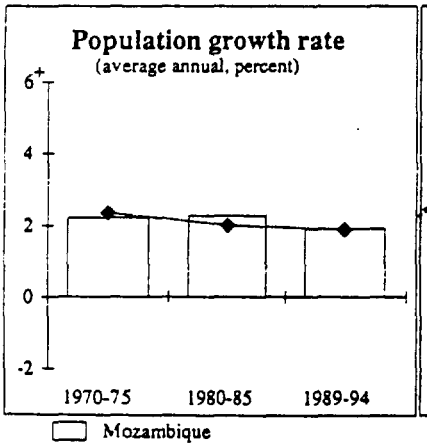
74. I am satisfied that the proposed Interim Fund Credit would comply with Resolution No. 184, adopted by the Board of Governors of the Association on June 26, 1996, establishing the Interim Trust Fund and I recommend that the President approve it.

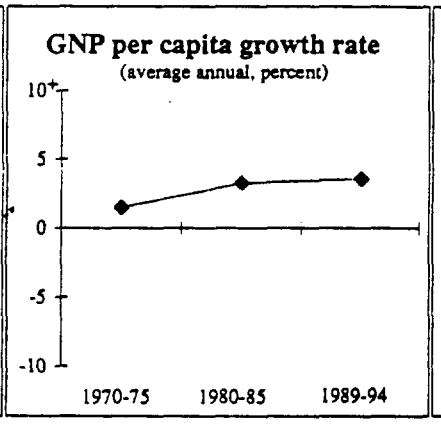
Gautam Kaji
Managing Director

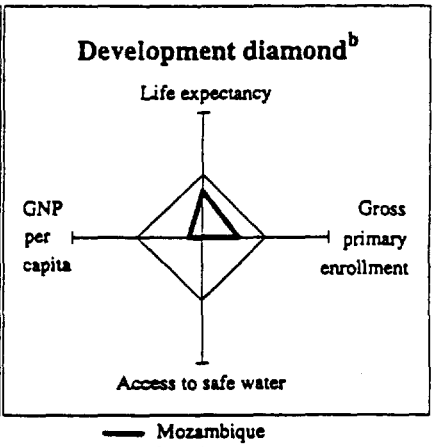
January 8, 1997

Mozambique

Indicator	Unit of measure	Latest single year 1970-75	Latest single year 1980-85	Most recent estimate 1989-94	Same region/income group: Sub-Saharan Africa	Same region/income group: Low-income	Next higher income group
Priority Poverty Indicators							
POVERTY							
Upper poverty line	local curr.	..	..	..	..	..	..
Headcount index	% of pop.	..	..	..	..	..	..
Lower poverty line	local curr.	..	..	..	..	..	..
Headcount index	% of pop.	..	..	..	..	..	..
GNP per capita	US$	..	..	80	500	390	1,670
SHORT TERM INCOME INDICATORS							
Unskilled urban wages	local curr.	..	..	..	..	..	..
Unskilled rural wages	"	..	..	..	..	..	..
Rural terms of trade	"	..	..	..	..	..	..
Consumer price index	1987=100	..	27	851	..	..	..
Lower income	"	..	..	..	..	..	..
Food[a]	"	..	..	..	..	..	..
Urban	"	..	..	..	..	..	..
Rural	"	..	..	..	..	..	..
SOCIAL INDICATORS							
Public expenditure on basic social services	% of GDP	..	..	13.1	..	..	..
Gross enrollment ratios							
Primary	% school age pop.	47	86	60	71	105	104
Male	"	..	97	69	77	112	105
Female	"	..	75	51	64	98	101
Mortality							
Infant mortality	per thou. live births	168	155	146	92	58	36
Under 5 mortality	"	..	..	218	161	101	47
Immunization							
Measles	% age group	..	39.0	23.0	51.4	86.2	77.4
DPT	"	..	29.0	19.0	53.5	89.1	82.0
Child malnutrition (under-5)	"	..	..	..	..	38.2	..
Life expectancy							
Total	years	42	45	46	52	63	67
Female advantage	"	3.2	3.3	3.1	3.5	2.4	6.4
Total fertility rate	births per woman	6.5	6.5	6.6	5.9	3.3	2.7
Maternal mortality rate	per 100,000 live births	..	300	1,512	..	..	..
Supplementary Poverty Indicators							
Expenditures on social security	% of total gov't exp.	..	..	..	..	..	..
Social security coverage	% econ. active pop.	..	..	..	..	..	..
Access to safe water: total	% of pop.	..	14.1	21.6	..	..	..
Urban	"	..	38.0	44.0	..	..	..
Rural	"	2.0	9.0	17.1	..	..	..
Access to health care	"	..	40.0	..	..	..	..







Mozambique
Low-income

Mozambique
Low-income

a. See the technical notes, p.387. b. The development diamond, based on four key indicators, shows the average level of development in the country compared with its income group. See the introduction.

Mozambique

Indicator	Unit of measure	Latest single year 1970-75	Latest single year 1980-85	Most recent estimate 1989-94	Same region/income group: Sub-Saharan Africa	Same region/income group: Low-income	Next higher income group
Resources and Expenditures							
HUMAN RESOURCES							
Population (mre=1994)	thousands	10,498	13,541	15,463	571,902	3,182,221	1,096,881
Age dependency ratio	ratio	0.89	0.88	0.90	0.94	0.66	0.63
Urban	% of pop.	8.6	19.4	32.7	30.6	28.3	55.9
Population growth rate	annual %	2.5	1.6	2.9	2.8	1.7	1.3
Urban	"	9.5	8.3	7.6	4.9	3.2	2.7
Labor force	thousands	5,929	7,091	8,390	254,250	1,590,533	488,647
Agriculture	% of labor force	85	84	83	65	67	36
Industry	"	7	8	8	9	14	26
Female	"	49	49	48	41	39	40
Labor participation rates							
Total	% of pop.	56	52	54	44	50	45
Female	"	28	26	26	37	41	36
NATURAL RESOURCES							
Area	thou. sq. km	801.59	801.59	801.59	24,273.83	40,391.42	40,594.43
Density	pop. per sq. km	13.10	16.89	18.73	22.90	77.44	26.66
Agricultural land	% of land area	60.04	60.06	60.17	50.61	52.42	41.05
Change in agricultural land	annual %	0.00	0.02	0.00	0.01	0.16	-1.38
Agricultural land under irrigation	%	0.08	0.20	0.25	0.86	17.84	11.40
Forests and woodland	thou. sq. km	..	186.83	173.29	5,323.14	7,632.00	5,969.25
Deforestation (net)	% change, 1980-90	..	..	0.75	..	..	..
INCOME							
Household income							
Share of top 20% of households	% of income	..	..	..	..	..	..
Share of bottom 40% of households	"	..	..	..	..	..	..
Share of bottom 20% of households	"	..	..	..	..	..	..
EXPENDITURE							
Food	% of GDP	..	..	29.3	..	..	..
Staples	"	..	..	8.7	..	..	..
Meat, fish, milk, cheese, eggs	"	..	..	10.8	..	..	..
Cereal imports	thou. metric tonnes	191	598	507	14,051	36,922	68,936
Food aid in cereals	"	34	379	958	5,079	8,516	5,771
Food production per capita	1987 = 100	140	101	89	102	115	102
Fertilizer consumption	kg/ha	0.1	0.1	0.1	5.3	58.5	46.3
Share of agriculture in GDP	% of GDP	..	47.7	28.7	19.5	27.6	14.0
Housing	% of GDP	..	..	8.7	..	..	..
Average household size	persons per household	..	4.3	..	..	..	..
Urban	"	..	..	..	..	..	..
Fixed investment: housing	% of GDP	..	..	3.2	..	..	..
Fuel and power	% of GDP	..	..	4.6	..	..	..
Energy consumption per capita	kg of oil equiv.	75	38	40	251	373	1,602
Households with electricity							
Urban	% of households	..	..	..	..	..	..
Rural	"	..	..	..	..	..	..
Transport and communication	% of GDP	..	..	10.0	..	..	..
Fixed investment: transport equipment	"	..	..	6.4	..	..	..
Total road length	thou. km	39	35	35	..	..	..
INVESTMENT IN HUMAN CAPITAL							
Health							
Population per physician	persons	18,865	48,534	..	..	..	3,064
Population per nurse	"	4,279	5,758	..	..	..	..
Population per hospital bed	"	851	918	1,156	1,316	1,034	592
Oral rehydration therapy (under-5)	% of cases	..	..	60	37	38	..
Education							
Gross enrollment ratios							
Secondary	% of school age pop.	5	7	7	24	48	63
Female	"	..	5	6	23	42	62
Pupil-teacher ratio: primary	pupils per teacher	69	62	53	40	39	..
Pupil-teacher ratio: secondary	"	22	40	40	..	20	..
Pupils reaching grade 4	% of cohort	..	..	51	..	..	..
Repeater rate: primary	% of total enroll	28	24	..	..	..	..
Illiteracy	% of pop. (age 15+)	..	72	67	53	35	..
Female	% of fem. (age 15+)	..	84	77	54	46	..
Newspaper circulation	per thou. pop.	8	6	6	12	..	236

World Bank International Economics Department, April 1996

Mozambique - Key Economic Indicators

Indicator	Actual			Estimate		Projected		
	1991	1992	1993	1994	1995	1996	1997	1998
National accounts (as % GDP at current market prices)								
Gross domestic product	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture[a]	36.0	30.5	30.9	28.8	30.1	28.5	28.3	27.6
Industry[a]	14.8	13.3	11.2	10.8	11.0	10.6	11.3	12.2
Services[a]	36.1	42.6	43.6	48.2	48.1	43.5	43.8	44.0
Total Consumption	102.6	103.0	98.1	94.1	82.7	79.4	74.4	70.5
Gross domestic fixed investment								
Government investment	19.7	17.6	16.4	20.9	19.0	15.3	16.4	16.3
Private investment (includes increase in stocks)	26.0	31.1	38.0	31.3	31.8	33.1	41.4	37.7
Exports (GNFS)[b]	21.6	23.6	21.3	23.3	27.7	27.2	28.3	30.8
Imports (GNFS)	69.8	75.5	73.8	69.6	61.2	55.0	60.4	55.3
Gross domestic savings	-2.6	-3.0	1.9	5.9	17.3	20.6	25.6	29.5
Gross national savings[c]	12.9	15.8	19.6	24.3	20.6	21.6	24.0	25.6
Memorandum items								
Gross domestic product (US$ million at current prices)	1433	1285	1467	1462	1484	1805	2007	2151
Gross national product per capita (US$, Atlas method)	84.8	70.6	78.9	73.4	70.1	80.0	87.0	94.0
Real annual growth rates (%, calculated from 1987 prices)								
Gross domestic product at market prices	4.9%	-0.8%	19.3%	5.0%	1.5%	5.7%	7.1%	7.8%
Gross Domestic Income	5.7%	-1.8%	18.2%	4.8%	2.0%	6.0%	6.5%	7.4%
Real annual per capita growth rates (%, calculated from 1987 prices)								
Gross domestic product at market prices	2.9%	-3.3%	13.2%	-1.5%	-3.2%	2.1%	4.5%	5.0%
Total consumption	-2.6%	-6.1%	4.9%	-6.7%	-15.0%	1.0%	-1.9%	-1.3%
Private consumption	-2.7%	-8.4%	6.0%	-12.1%	-8.2%	1.4%	-1.4%	-0.9%

(continued)

Mozambique - Key Economic Indicators (Continued)

Indicator	Actual			Estimate		Projected		
	1991	1992	1993	1994	1995	1996	1997	1998
Balance of Payments (US$m)								
Exports (GNFS)[b]	309.6	304.0	312.1	340.6	411.5	491.0	567.4	662.9
Merchandise FOB	162.3	139.3	131.8	149.5	169.0	216.0	269.4	339.8
Imports (GNFS)[b]	893.6	859.7	957.8	1017.5	908.2	993.1	1212.6	1190.4
Merchandise FOB	898.8	855.0	954.7	1018.5	727.0	794.6	996.7	968.6
Resource balance	-584.0	-555.7	-645.7	-676.9	-496.7	-502.0	-645.3	-527.5
Net current transfers (including official current transfers)	30.6	33.0	34.6	35.4	38.5	35.0	33.3	32.6
Current account balance (after official capital grants)	-236.7	-239.0	-321.2	-312.9	-355.7	-438.5	-617.9	-549.9
Net private foreign direct investment	22.5	25.3	32.0	35.0	45.0	75.0	128.8	149.4
Long-term loans (net)	-168.0	-115.9	-139.0	-42.0	14.8	141.6	250.3	156.9
Other capital (net, including debt relief, short term, and errors and omissions)	394.9	369.5	382.0	372.4	355.6	380.9	318.8	273.8
Change in reserves[d]	-12.7	-39.8	46.2	-52.4	-59.6	-159.0	-80.0	-30.2
Memorandum items								
Resource balance (% of GDP at current market prices)	-40.7%	-43.2%	-44.0%	-46.3%	-33.5%	-27.8%	-32.1%	-24.5%
Real annual growth rates (1987 prices)								
Merchandise exports (FOB)	23.7%	-5.8%	-6.0%	12.8%	7.0%	20.8%	31.8%	29.8%
Merchandise imports (CIF)	3.1%	-8.4%	19.2%	3.3%	-34.9%	9.3%	24.7%	-3.4%
Public finance (as % of GDP at current market prices)[e]								
Current revenues	21.7	21.1	20.0	17.6	18.3	17.7	18.6	18.8
Current expenditures	22.3	24.2	21.4	22.9	16.6	15.5	17.1	16.7

(Continued)

Mozambique - Key Economic Indicators (Continued)

Indicator	Actual			Estimate		Projected		
	1991	1992	1993	1994	1995	1996	1997	1998
Current account surplus (+) or deficit (-)	-0.5	-3.1	-1.4	-5.2	1.7	2.1	1.5	2.1
Capital expenditure	24.4	23.2	20.8	24.5	22.5	16.9	18.1	18.2
Foreign financing	25.5	24.1	20.8	30.6	22.0	16.5	18.2	17.6
Monetary indicators								
M2/GDP (at current market prices)	34.5	36.1	37.0	36.8	37.3	28.1	28.4	28.5
Growth of M2 (%)	35.6	59.3	78.8	57.6	54.7	15.8	19.7	17.9
Private sector credit growth / total credit growth (%)	37.5	36.7	21.8	65.7	..	..	..	..
Price indices(1987 =100)								
Merchandise export price index	96.3	87.8	88.4	88.8	93.8	99.2	93.9	91.2
Merchandise import price index	120.8	125.5	117.6	121.5	133.2	133.2	134.0	134.8
Merchandise terms of trade index	79.7	69.9	75.1	73.1	70.4	74.5	70.1	67.7
Consumer price index (% growth rate)	33.3%	45.1%	42.3%	63.1%	54.4%	44.8%	13.5%	10.0%
GDP deflator (% growth rate)	46.2%	53.3%	46.5%	50.8%	50.2%	44.3%	15.0%	9.4%

a. As share of factor cost GDP.
b. "GNFS" denotes "goods and nonfactor services."
c. Includes net unrequited transfers excluding official capital grants.
d. Includes use of IMF resources.
e. Refers to Central Government.

Mozambique - Key Exposure Indicators

Indicator	Actual			Estimate		Projected		
	1991	1992	1993	1994	1995	1996	1997	1998
Total debt outstanding and disbursed (TDO) (US$m)[a]	4716.7	5185.7	5263.5	5483.0	5581.0	5724.0	6031.0	6236.0
Net disbursements (US$m)[ab]	268.8	316.2	258.4	341.0	356.1	508.4	586.3	442.5
Total debt service (TDS) (US$m)[a]	484.4	486.5	495.0	465.0	428.3	371.9	368.9	517.7
Debt and debt service indicators[c] (%)								
TDO/XGNFS[d]	1523.6	1705.8	1686.6	1609.7	1356.4	1165.7	1063.0	940.7
TDO/GDP	329.0	403.5	358.7	375.0	376.1	317.1	300.4	289.8
TDS/XGNFS[d]	156.5	160.0	158.6	136.5	104.1	75.7	65.0	78.1

a. Includes public and publicly guaranteed debt, private nonguaranteed, use of IMF credits and net short-term capital before debt restructuring. Excludes Cahora Bassa private debt and military debt to Russia.

b. Actual disbursements including debt relief.

c. Scheduled Debt Service.

d. "XGNFS" denotes exports of goods and non-factor services.

Mozambique- External Financing Requirements and Sources of Financing

Indicator	Estimated		Projected		
	1995	1996	1997	1998	1999
Total financing requirements	790	1010	2376	1138	1042
Current account deficit (excl grants)	695	709	879	810	796
Amortization (incl. IMF)	282	226	204	297	290
Changes in arrears (increase-) [a]	-193	54	1257	50	0
Changes in reserves (increase +)	45	145	97	42	17
Errors and omissions (outflow +)	-40	-124	-61	-61	-61
Total identified financing	667	700	860	808	789
Direct foreign investment	45	75	129	149	157
Grants	339	271	261	260	259
Loans	282	354	471	398	373
Official creditors	235	353	326	318	297
Multilateral	217	333	311	308	287
of which: IDA	153	216	180	180	175
of which: IMF	0	18	37	37	18
Bilateral and other	18	20	15	10	10
Commercial	48	60	199	128	122
Debt relief/possible debt relief	123	310	1516	330	253
Remaining gap	0	0	0	0	0

a/ Excludes Cahora Bassa private debt and military debt to Russia.

Status of Bank Group Operations in Mozambique
IBRD Loans and IDA Credits in the Operations Portfolio

Project ID	Loan or redit N	Fiscal Year	Borrower	Purpose	Original amount in US$ millions IBRD	IDA	Cancel.	Undis.	Diff. betw. expect. and actual disburs.[a]	Last ARPP Supervision Rating[b] D.O.	I.P.
Number of Closed Loans/Credits: 8											
Active Loans											
MZ-PA-1762	C20660	1990	GOM	ECONOMIC & FINANCE M		21.00		3.88	1.13	S	S
MZ-PA-1765	C21750	1991	GOM	AGRI.REHAB.&DEV		15.40		10.89	6.92	S	U
MZ-PA-1770	C20650	1990	GOM	TRNS.REH.(BEIRA CORR		40.00		14.27	9.78	S	S
MZ-PA-1776	C22000	1991	GOM	EDUCATION II		53.70		24.35	13.66	S	S
MZ-PA-1777	C26280	1994	GOM	SERC		200.00		61.43	43.79	S	S
MZ-PA-1780	C26290	1994	GOM	GAS ENGINEERING(ENGY		30.00		16.74	3.67	S	S
MZ-PA-1781	C23370	1992	GOM	AGR.SER. REHAB.		35.00		28.33	12.26	S	S
MZ-PA-1784	C20810	1990	GOM	INDUSTRIAL ENTERPRIS		50.10		36.75	29.02	S	S
MZ-PA-1787	C19890	1989	GOM	HEALTH & NUTRITION		27.00		4.47	-25.85	S	S
MZ-PA-1790	C23740	1992	GOM	FIRST ROAD & COASTAL		74.30		41.92	-3.63	S	S
MZ-PA-1791	C25300	1993	GOM	LOCAL GOVERNMENT EN		23.20		17.62	6.65	S	S
MZ-PA-1792	C27880	1996	GOM	HEALTH SEC RECOVERY		98.70		95.77	12.43	S	S
MZ-PA-1793	C20330	1989	GOM	HSEHOLD EGY CREDIT		22.00		10.93	-13.34	S	S
MZ-PA-1794	C20820	1990	GOM	SMALL AND MEDIUM-SCA		32.00		8.67	4.64	U	S
MZ-PA-1796	C24790	1993	GOM	RURAL REHABILITATION		20.00		16.10	13.65	U	U
MZ-PA-1797	C24360	1993	GOM	CAPACITY BUILDING(HU		48.60		40.78	24.34	U	U
MZ-PA-1801	C24870	1993	GOM	FOOD SECURITY		6.30		5.10	3.29	S	S
MZ-PA-1802	C24540	1993	GOM	MAPUTO CORRIDOR		9.30		5.67	-2.71	S	S
MZ-PA-1804	C25990	1994	GOM	2ND ROAD AND COSTAL		188.00		145.42	21.70	S	S
MZ-PA-1810	C24370	1993	GOM	LEG & PUB SEC. CAPAC		15.50	2.93	9.29	7.30	U	U
MZ-PA-1811	C26070	1994	GOM	FINANCE SECTOR CAPAC		9.00		6.74	3.09	U	S
TOTAL					0.00	1019.10	2.93	605.13	171.77		

	Active Loans	Closed Loans	Total
Total disbursed (IBRD and IDA)	465.93	515.97	981.90
Of which repaid	0.00	0.67	0.67
Total now held by IBRD and IDA	1016.17	495.23	1511.40
Amount sold	0.00	0.00	0.00
Of which repaid	0.00	0.00	0.00
Total undisbursed	605.13	8.39	613.52

a. Intended disbursements to date minus actual disbursements to date as projected at appraisal.

b. Following the FY94 Annual Review of Portfolio Performance (ARPP), a letter-based system was introduced (HS=highly satisfactory, S=satisfactory, U=unstatisfactory, HU=highly unsatisfactory);
see *Proposed Improvements in Project and Portfolio Performance Rating Methodology* (SecM94-901), August 23, 1994.

Note: Disbursement data is updated at the end of the first week of the month.

Matrix of Actions
The Reform Agenda Supported by the TERC

Objectives (CAS)	Policy Area	Specific Measures	Status
Restore macroeconomic stability			
	Financial Sector	split commercial bank from central bank.	done (1992)
		prepare BCM for sale (completed portfolio review, contracted sales advisor)	done (1996)
		privatization of BCM (1996)	***Condition of Negotiation (done)***
		distribution of BPD Sales Prospectus	***Condition of Negotiation (done)***
		privatization of BPD, ***BPD will cease to exist as lending institution***	March 1997 ***Condition of Second Tranche***
		conduct loan portfolio review of BCM and BPD	done, 1996
		conduct off-site and on-site supervision of all banks on a regular basis	started in 1996
	Exchange rate	liberalize and unify exchange rate.	done (1992)
	Fiscal reform	introduce three-year rolling investment program (PTIP)	done regularly since 1989
		produce budget for passage by Parliament	done regularly since 1993
		adopt Sector Investment Programs in health, roads, agriculture, education and water	done in health and roads, to be done for the rest (1996-97)
		develop a Fiscal Reform Strategy that covers budgetary framework, accounting system, aid management.	***Condition of Negotiation (done)***

Customs Reform	establish customs reform unit	done (1995)
	contract pre-shipment inspection service	done (1996)
	contract private firm to manage and modernize customs administration for three years	done (1996)

Private Sector Development

Price Liberalization	eliminate administered retail and wholesale prices	done
	eliminate minimum producer prices	to be done (1996-98)
Privatization	privatize over 700 commercial and industrial firms, including 32 large enterprises	done by mid-1996
	complete privatization of small and medium-scale enterprises, including 30 large enterprises	to be done (end 1997)
Enterprise Subsidies	reduce budget subsidization of public enterprises to less than one percent of GDP	done (by 1993)
	limit indirect subsidies to enterprises through non-payment of counterpart funds, credits at below market rates, and on-lent funds etc.	on-going
	estimate the level of disbursement and debt service due of funds on-lent from donor sources to enterprises	***Condition of Second Tranche***
Business Environment	revise investment code of 1993	done (1995)
	establish and revise mandate of Center for Promotion of Investment	to be done (1996)
	simplify procedures to register and operate businesses	1997 onwards
Trade and Tariff Reform	rationalization and reduction of import tariffs	(1991)
	eliminate discretionary exemptions	partially done (1996)

	further rationalize indirect taxes by lowering the average nominal duty rate and reducing the scope and level of the consumption tax	***Condition of Negotiation (done)***
	establish and carry out a system for complete reconciliation of all import taxes due and paid	***Condition of Second Tranche***
	submit VAT law to Parliament	***Condition of Second Tranche***
	Introduce VAT system	mid-1998
	review duty exemptions regime for exporters	to be done

Promote High Growth Potential Sectors

Agricultural reform; cashew subsector	eliminate quantitative restrictions on exports of raw cashew	done (1995)
	reduce export tax to 20 percent	done (1995)
	reduce export tax to 14 percent	done (1996)
	phase out the export tax	by 2000
	design a monitoring survey of cashew farmers	***Condition of Negotiation (done)***
	analyze the results of the cashew monitoring survey	June 1997
Transport reform; railway and ports subsector	establish a Board for CFM and appointed members.	done (1995)
	Private concession of sugar, coal and citrus terminals at Maputo Port	done (1994-95)
	Adopt restructuring plan for CFM	done (1996)
	Issue bids for the concession of the port services, remaining port terminals, and railway lines at CFM-South	March 1997
	Complete the evaluation of bids for the concessioning of the port services, remaining port terminals, and railway lines at CFM-South	***Condition of Second Tranche***

MOZAMBIQUE

THIRD ECONOMIC RECOVERY CREDIT

SUPPLEMENTARY LOAN DATA SHEET

Timetable of Key Events

(a)	Time taken to prepare:	8 months
(b)	Operation prepared by:	Ministry of Planning and Finance; Bank of Mozambique; Ministry of Transport, CFM.
(c)	Project preparation:	March 1996
(d)	Appraisal mission:	July 1996
(e)	Negotiations:	December 1996
(f)	Planned date of effectiveness	February 1997

Previous Adjustment Operations

Second Rehabilitation Credit (FY88, Cr no 1841)
Third Rehabilitation Credit (FY89,Cr no 2021
Economic Recovery Credit (FY 92,Cr no 2384)
Second Economic Recovery Credit (FY94, Cr no 2628)
Second Tranche Release Memorandum, July 1995
Third Tranche Release Memorandum,October 1996

REPÚBLICA DE MOÇAMBIQUE

MINISTÉRIO DO PLANO E FINANÇAS

GABINETE DO MINISTRO

Nº 1282 /GM-MPF/96

Maputo, 26 de Dezembro de 1996

James Wolfensohn, President
The World Bank
1818 H Street, N.W.
Washington, DC., 20433
United States of America

Dear Mr. Wolfensohn,

Re: Mozambique - Third Economic Recovery Credit
Letter of Development Policy

1. The purpose of this letter is to report to you the progress made in the implementation of the adjustment program initiated in 1987, in particular during the period covered by the Policy Framework Paper for 1994-96 and the Second Economic Recovery Credit (SERC). The policies and measures described below are consistent with the PFP for 1996-98 and aim at continuing and strengthening the adjustment process in Mozambique. In support of this program the Government requests $100 million from the Interim Trust Fund for a Third Economic Recovery Credit (TERC).

Background

2. As you are aware, Mozambique 's first general elections were successfully held in October 1994, a new government has been formed and the Assembly of the Republic is fully functioning. The demobilization of soldiers has been completed, millions of displaced persons have resettled in their former towns and villages, and a new smaller national army has been formed with soldiers from both sides. Peace prevails throughout the country.

3. Over the 1993-95 period, the economy grew on average by nearly 10 percent per annum, although with large variations from year to year, as a result of exogenous factors, including the weather. This year also promises strong growth, around 6

percent, resulting mainly from an excellent agricultural season. Macroeconomic imbalances have been, to some extent, narrowed. In particular, the fiscal deficit before grants has been reduced from 30 percent in 1994 to 20 percent in 1995. Inflation has decelerated from an annual rate of 70 percent in 1994 to 50 percent in 1995 and is not expected to exceed the 22 percent programmed for 1996. The external current account deficit has been reduced from 36 percent of GDP in 1994 to 21 percent in 1995, largely as a result of good export performance.

4. This generally satisfactory performance is to be attributed to the factors referred to above, including the resettlement of displaced persons in rural areas. However, I believe that progress in policy reform, which has continued throughout the period under the SERC, has been an important, although immeasurable positive factor. I am particularly satisfied with achievements in several critical areas. Among these I would cite the acceleration in the privatization process. Specifically, eleven of the fourteen large enterprises which accounted for more than half the bad loans of the banking sector have now been transferred to private hands. Also, the Banco Comercial de Moçambique (BCM) has been privatized and I find great satisfaction in the expansion and diversification of the financial sector that has occurred in the last two to three years, which was one of the main objectives of the previous adjustment operation. I am happy to see some progress in deregulation of commerce and industry, as a result of an intensified dialogue with private business, following on the analyses carried out, notably, with support of your institution. Besides the economic and financial domains, progress in delivering education and health services, which increased as much as 20 percent in volume terms, has been an additional source of satisfaction to the Government of Mozambique.

5. However, despite these positive developments, I am not yet entirely satisfied with progress in either outcomes or policy reforms. First, I would like to see a more firmly established growth path. The supply response, although real, clearly needs further impulse. Equally important and probably even more pressing in my mind, is the objective of macroeconomic stabilization: inflation is still too high and if continued threatens future growth and poverty reduction. The internal as well as external deficits are similarly not sustainable over the long term. In addition, the burden of our external debt is beyond our capacity even with the best of policies. This particular problem clearly calls for special assistance from the international community.

6. In view of the above, the specific program that I propose for the next two years addresses both demand management deficiencies and supply side bottlenecks. Specifically the following will constitute the elements of the policy package that I describe in this letter. On the demand management side, the program will seek further progress in three broad areas:

(a) **Financial sector reform** which includes monitoring of BCM after its privatization, privatization of BPD, and strengthening the banking supervision function;

(b) **Budget management reform**, already underway, addresses the budgetary framework, accounting, aid management and public investment, human resource development and fiscal governance;

(c) **Indirect subsidies to enterprises** which can occur through three main channels -- counterpart funds obligations, bank credits at below market rates, on-lending arrangements for external grants and credits-- are to be contained and eventually eliminated.

7. Regarding the supply response, I intend to address three specific areas:

(a) **Tariff and indirect tax rationalization**, also well underway, will seek to reduce existing distortions while protecting fiscal revenue;

(b) **Cashew liberalization** involves the elimination of quantitative restrictions and the agreed reduction in the export tax while monitoring the policy's poverty and gender impact;

(c) **CFM restructuring** with specific emphasis on completing the concessioning of remaining services in CFM-South.

8. As is evident from this list, much of the program for the next two years is in direct continuation of, or builds upon, reforms undertaken since the first economic recovery credit supported by the Bank, the IMF, and other donors. It reflects the commitments made at the last Consultative Group Meeting.

Improving Macroeconomic Management

9. In general terms the Government will endeavor to maintain a favorable macroeconomic framework, in line with the parameters agreed under the PFP for 1996-98 and supported by the ESAF program approved by the IMF in June 1996. As you will recall, the principal objectives under that program are to (i) achieve an average annual growth rate of non-energy GDP of 5 percent; (ii) reduce inflation to 10 percent by end-1998; and (iii) increase gross international reserves to the equivalent of four months of imports and non-factor services. In pursuit of macroeconomic stabilization the Government will continue to maintain a floating exchange rate regime while introducing an inter-bank market for foreign exchange. At the same time, the central bank will endeavor to achieve a better control of base money, an elusive objective in the past, but an essential one for controlling monetary expansion and reducing inflation. As you know the introduction of indirect monetary instruments, which was to begin under the SERC, has had to be postponed because of dificult condition of the financial sector, but remains an objective over the medium term. Indeed, the restructuring of the financial sector, notably the privatization of the state-owned banks, is at the heart of our policy reform program.

Financial Sector Reform

10. **Privatization of BCM.** Following the commitment made by the Government at the March 1995 Consultative Group meeting and reiterated at the April 1996 meeting, Banco Comercial de Moçambique (BCM) has been privatized. The formal agreement with the private consortium (the sole bidder) which purchased the bank, led by the Mello Group of Portugal, was signed on July 24, 1996. Under the agreement, the consortium owns 51 percent of the new bank. The resulting shareholding structure of the new BCM is: Banco Mello de Investimento (5%), Banco Mello Comercial (2.7%), National Merchant Bank of Zimbabwe (17.85%), Impar (25.4%), the Government of Mozambique (29%), and the bank's workers (20%). The consortium will invest a further $25 million in the bank over the next three years. The Mello group has provided a management team. The balance sheet was sold "as is" but the Government has assumed responsibility for 50 percent of the "other assets, net" which represents a contingent liability of around $12 million.

11. The Government's representative on the Board will retain veto power during the next (two) years over three important matters: dividend distribution, outside investments, and changes in the by-laws. However, more importantly, the Government will take steps to strengthen banking supervision, as explained below.

12. **Privatization of BPD.** The prospects for privatization of Banco Popular de Desenvolvimento (BPD) by March 1997, also a commitment made at the last CG, are more problematic. After extensive consultation with professional experts, the Government has decided to follow a strategy that offers the widest possible range of options. The Sales Adviser has been instructed accordingly. Privatization in this context, first of all, will mean the sale of between 51 percent to 80 percent to a private qualified buyer. Second, the bank can be sold whole or in part (e.g., some of the bank's 204 branches). Third, since the Government considers it important to maintain a nationwide branch network of banks, any remaining parts of the bank that are not privatized may be converted into a government owned savings bank, namely, an institution which provides no credit and invests its mobilized savings wholesale, preferably in government guaranteed instruments. The Government does not plan to create another state owned credit institution.

13. **Banking Supervision.** The central bank's supervision function has improved over the past two years, as provided for under the SERC. The Department's professional staff now numbers eleven; weekly, monthly, quarterly, and annual reporting by financial institutions are generally complied with; on-site banking supervisions have already been performed in most banks. However, in view of the diversification of the sector (including the arrival of new players and most importantly the privatization of the two state banks) and in the expectation that the sector will further expand, the supervision function must be considerably strengthened. To that effect, the following program of actions will be implemented as a matter of urgency: (i) staffing levels and the structure of the supervision department of the Bank of

Mozambique will be reinforced with the number of bank supervisors being increased to at least fourteen by the end of 1996; (ii) a comprehensive training program will be developed before the end of the year while existing programs continue; (iii) on-site supervision will be undertaken on all financial institutions on a regular basis; (iv) off-site supervision will continue to be improved;(v) the Banking Law will be up-dated to fully reflect modern bank supervisory practices - with the new law expected to be submitted to Parliament in 1997.

14. To assist in the implementation of the above program over the next eighteen months, particularly the on-site supervision component, the central bank will hire an international, experienced bank supervisor for an initial period of six months. For that purpose, the Government has requested the support of ODA.

15. Finally, the Central Bank has undertaken to make accessible to IDA, on a confidential basis, the documentation necessary to permit a full assessment of progress in off-site and on-site supervision.

Budget Management Reform

16. Mozambique's budgetary system is in the process of being fully adapted from an instrument for central planning to a tool for general economic and fiscal policy. The budget system at present also needs to manage large volumes of external aid which finance both current and investment expenditures. At the same time, in the context of a full-fledged democracy, the budget and budgetary approval process need to become open, transparent, and more accountable.

17. The Government has made important progress in addressing these challenges. As an instrument of resource allocation, the budget has reoriented expenditure from security to developmental and social aims, including the judicial system. Since 1989, a three-year rolling investment program (the PTIP) has been prepared annually and progressively improved as a programming tool for sectoral and project allocation. While not yet complete, its coverage has been expanded, notably at provincial level. The budget has been published every year since 1993 and, in 1995, it was approved for the first time by the Assembly of the Republic.

18. The process of full fiscal reform, however, is going to be a long one. A new accounting system, including computerization, with a detailed functional classification has to be developed and implemented on a central and decentralized basis. The budget framework needs to reflect the execution of large amounts of donor financed expenditure which still remain outside the budgetary accounting system. At the same time, investment and recurrent expenditures have to be much more rigorously separated. This is necessary first to arrive at an accurate measure of public investment (vastly over-estimated at this time). It is needed also to help determine the proper balance between investment and recurrent allocations and the sustainability of overall expenditures.

19. To implement needed reforms, the Government and the World Bank have jointly embarked on a multi-year Fiscal Management Review (FMR) process. The first phase of this effort, started in November 1995, will be the formulation of a draft Fiscal Reform Strategy by Government by December 1996, the main components of which are summarized below.

20. **Budget System Reform.** The reform of the budget system calls for actions in several areas: (i) a new budget law (Lei de Enquadramento Orçamental) as a basis for the implementation of reforms to improve budgeting and accounting; (ii) the introduction of a new classification system that would permit both functional and economic presentation of government accounts as well as its territorial distribution; (iii) computerization of the public accounting system (being addressed with assistance from SIDA); (iv) the rationalization of the treasury function (cash flow management) to smooth out fluctuations in cash availability resulting from the differing patterns of receipts and outlays; and the complementary function of (v) debt management, both internal and external.

21. **Aid Management and Public Investment.** Under the reform strategy, the Ministry of Planning and Finance will seek to: (i) unify and rationalize aid and recurrent budgets; (ii) involve donors in the implementation of the new accounting system; (iii) develop sector programs, already adopted in roads and health and being initiated in agriculture and education; (iv) prepare for further decentralization; (v) improve donor coordination, essentially through a more systematic exchange of information and the involvement of donors in the preparation of the PTIP itself.

22. **Fiscal Governance.** The Assembly of Republic has rapidly developed a role in the approval of resource allocation. The Government intends to increase the publication and dissemination of key budget and planning documents on a regular basis and to improve auditing and accounting practices.

23. **Human Resource Development.** The implementation of our fiscal reform strategy will require a considerable upgrading of existing staff, and filling the main skill gaps that exist, such as with auditing and computing. Such an upgrading will be impossible without addressing the reward structure and public sector management system. Key components of the action program in this area will therefore likely include: (i) a massive training effort including provincial governments and sectoral departments of administration and finance; (ii) advanced implementation of civil service reform within Planning and Finance including revision of salary structure; and (iii) strengthening staffing in the Ministry of Finance and Planning and the financial units in sectoral ministries. Considerable external assistance will be required if staff training and salary enhancement components of this reform are to be implemented successfully.

Indirect Subsidies to Enterprises

24. Over the past years the Government has taken measures to

reduce subsidies to enterprises in order to rationalize the use of scarce fiscal resources and induce efficiency among commercial enterprises. Indeed, direct budgetary subsidies are now less than one percent of GDP. Also the proportion of bad borrowers and leakages through the financial system which involve indirect subsidization have been reduced, as a side benefit of privatization. The Government intends to tackle the remaining sources of indirect subsidies which occur through various forms of financial transfers, as explained below, noting that a great deal has already been achieved in this area.

25. **Counterpart Funds.** Substantial progress has been made in reducing and limiting indirect subsidies provided in the form of exemptions of counterpart fund payments generated from the sale of donor import support funds. This has been possible due to the improvement in the accounting and monitoring of these funds both within Treasury and Bank of Mozambique. Following instructions issued in mid-1995 by the Ministry of Planning and Finance, exemptions are now restricted to a few enterprises providing social services, notably Medimoc (for the purchase of medicines intended for free distribution). A program is being implemented for the collection of arrears in respect of counterpart fund payments, under arrangements with Treasury (letras do tesouro). Of the stock of arrears as of the end-1995, of Mt 46 bn, some Mt 23 bn will be recovered this year and the stock will be fully liquidated by 1998. In addition, the Government will ensure the due payment (on commercial terms) of short term credits (acordos de creditos) which, as of end 1995, totaled MT. 148,3 bn.

26. **On-lent Funds.** In addition, the Government now intends to significantly improve the management of on-lent funds (from external grants and credits) to enterprises. These, in effect, constitute medium term credit facilities provided to enterprises, through Subsidiary Agreements (acordos de retrocessão), for the payment of goods and services (typically machinery) donated or financed by an external source. To date, the terms (repayment period, interest rate, etc.) applied to these agreements have varied a great deal (on a case-by-case basis and often reflecting the conditions specified by donors and creditors) and generally implying the payment of below market interest rates. Moreover, debt service payments under these agreements are, in some cases, overdue but not enforced because of the lack of appropriate accounting and monitoring systems. On important area, where corrective action is being taken, is the proper recording and updating of amounts actually disbursed and, consequently, of debt outstanding.

27. In order to limit indirect subsidies resulting from delays in debt servicing and differential terms applied to each credit, the Government will from now on: (i) define guidelines for setting the terms and conditions for the on-lending of funds to commercial borrowers; (ii) estimate the stock of the outstanding debt under these agreements, based on the level of actual disbursements, by mid-1997; and (iii) program identified repayments due specifically under these agreements in the 1997 budget. To facilitate monitoring, the Government plans to establish a computerized domestic debt

information system to record the amounts, disbursements, maturity and terms of these agreements. This system will be in place by mid-1997.

28. **Central Bank Refinancing Facilities.** In accordance with the commitments outlined under the PFP, the provision of below market rate credits provided to some enterprises under refinancing facilities through the banking system have been suspended as of mid-1996. The central bank will enforce the payment of the rediscount rate on all bank overdraft or rediscount operations and will apply stipulated financial penalties in case of default.

Supply Response Measures

Tariff and Indirect Tax Rationalization

29. The establishment of a properly functioning market economy, is the central objective of the Government's economic reform. In this context, as you know, all prices, except for transport, and utilities, have been liberalized, the exchange rate is market-determined, and so are interest rates. Similarly we are in the process of radically simplifying the administrative and regulatory framework to improve the business climate. Serious distortions persist, however most of which result from the trade regime, the malfunctioning of customs, and the indirect tax system.

30. The Government has identified the problems in the current system as follows: (i) high average nominal tariff rates; (ii) excessively high nominal rates on production inputs, which may lead to lower effective protection of domestic production than desirable; (iii) a multiplicity of exemptions on import tariffs and indirect taxes, provided under various regimes, including the investment law, industrial inputs, emergency imports, political parties' imports, provisions for miners, plus ad hoc exemptions; (iv) absence of an effective free trade regime for exports; and (v) high and cascading indirect taxes, in particular a broad-based consumption tax and a general turnover tax. These undesirable features and the complexity of the tax system in general, combined with serious administrative weaknesses, particularly in Customs, result in large revenue shortfalls, very uneven distribution of the tax burden, and other economic distortions.

31. A number of measures have been taken to address some of these problems. Thus, last year, the scope of exemptions under the emergency and miners' regimes has been greatly restricted. An enhanced pre-shipment inspection contract, which will involve full reconciliation of taxes due and paid, has been signed and has begun to operate. The bulk of the difficulties noted above, however, remains.

32. The reform the Government now proposes to undertake over the next three years seeks to achieve the following objectives: (i) lower the nominal average tariff; (ii) achieve, to the extent possible, more even effective protection levels through restructuring tariffs on inputs and outputs and rigorous implementation across importers; (iii) drastically reduce exemptions and incorporate zero duties in

the tariff code for eligible goods, rather than granting exemptions on the basis of who the user is (except in the context of international agreements and conventions); (iv) effectively put exports on a free trade basis, i.e. free them from indirect taxation; (v) replace existing domestic indirect taxes by a VAT plus a selective excise tax; (vi) implement the overhaul of Customs administration and strengthen tax administration; (vii) ensure that government revenue from the combined reform of tariff and indirect taxation is preserved, particularly during the transition period from the present to the future system.

33. It is the Government's expectation that the pursuit of these objectives will, in due course, create a simpler and more effective tax and tariff system. In observance of basic principles of taxation, the Government will endeavor to assign the protective function to the tariff structure and the revenue function to domestic indirect taxes. Therefore, domestic indirect taxes will be made to apply to domestically produced goods and imports, in a non-discriminatory manner and exports will be freed from indirect taxation. As the domestic indirect tax system is modernized, its share in revenue generation relative to import duties will increase over time. The Government will aim at setting indirect tax and tariff rates as low as possible, subject to the revenue constraint. In this manner, the incentive to evade such taxes or to routinely request exemptions will be diminished.

34. **Customs Administration.** The Government is acutely aware that the reform of customs and the rationalization of tariff and taxes are strictly complementary undertakings. Success in one without the other would be futile. The reform of the administration has three components: (i) pre-shipment inspection: a private company has been contracted and will undertake full reconciliation of all import taxes due and paid, using the relevant import documentation, namely, the Clean Report of Findings (CRF) and the Despacho Aduaneiro. A full reconciliation system will be in place by March 1997; (ii) management of customs: a specialized firm, has been contracted to manage customs over a period of three years. For that purpose, this firm will place executive experts at the main entry points to manage Customs; and (iii) customs restructuring: a program of training, procedural review, computerization, and reorganization will be implemented over a period of three years. The Government appreciates the World Bank's support to finance the Customs Restructuring Unit which has been set up at the Ministry of Planning and Finance to oversee this process of reform.

35. **Tariff and Indirect Tax Rationalization.** To facilitate the transition between the current regime of nominal duty rates plus various exemption regimes to one of low nominal rates and few exemptions, the Government has reduced the rates of all import categories by at least 5 percentage points. In this first phase, the new duty structure includes five rates: zero for a limited category of special and/or essential items, 2.5 percent for raw materials, 5 percent for capital goods, 7.5 percent for intermediates, and 35 percent for consumer goods. Due to revenue constraints there is no scope at this time for further reducing the top rate below 35 percent. The

general customs handling fee (currently at 5 percent) will be replaced by a service fee of 1 percent. Over the medium term, once administrative improvements in Customs have materialized and the revenue base has expanded, the top duty rate will be lowered and the number of rates further reduced to four rates (by applying 5 percent to raw materials and capital goods).

36. Exemptions and rate reductions will be drastically limited, except for duty relief for exports. The exemption regimes that the Government intends to modify immediately include, in particular: (i) duty and indirect tax exemptions under the investment code, and; (ii) the import duty reductions under the special tax regime for industrial inputs;. In the first phase, three important measures will be taken. Duty exemptions currently granted under the investment code will be restricted to those on imports of capital goods for new investments and the special regime for industrial inputs will be immediately eliminated. Simultaneously, exemptions for NGOs and for political parties will be closely monitored while exemptions for government agencies and public enterprises will be limited to situations where bilateral agreements apply. The Government will keep the export regime under review with the aim of making it more attractive by putting exporters as close as possible to a free trade status.

37. The turnover tax (imposto de circulação) at its present rates will continue to apply to both domestic and imported goods, until it is replaced by a VAT system. In the meantime the Government will concentrate efforts on accelerating preparation of VAT for its introduction in 1998, both to remove the cascading effect inherent in the turnover tax and to reduce incentives for evasion. The Government will submit the VAT Law to Parliament in the course of 1997.

38. Finally, the Government is narrowing the level and incidence of the consumption tax to typically excisable products such as alcohol, cigarettes, cosmetics, and certain luxury items at equal rates for domestically produced and imported goods. In the medium term and if revenue considerations allow, the Government may further restrict the range of goods subject to consumption tax and reduce tax rates.

Cashew Liberalization

39. As you know, the Government took the important decision, despite strong resistance from various circles, to liberalize the cashew pricing and trade regime with a view to promoting production and exports and thereby raising the incomes of hundreds of thousands of small farmers engaged in this activity. This decision involved the liberalization of rawnut exports and the gradual removal, and eventual elimination after four years, of the tax (surcharge) on raw nut exports. In this manner, a new incentive framework is being established within which an efficient cashew processing industry can develop.

40. In application of the above decision the export surcharge for the 1995/96 season was reduced from 26 percent to 20 percent. It has further been reduced to 14 percent for the

1996/97 season and will continue to be reduced according to terms specified in the letter of November 1995 from the Minister of Commerce to the Bank. At the same time, the cashew working group (Government, processors and traders) is to carry out a study that will focus on complementary measures to make the industry more competitive. Should the study bring any new salient facts to bear with regard the export tax, the schedule would be reviewed.

41. As I have indicated, this new policy has, as a principal objective, to improve farmers' incomes, a major component of the Government's poverty alleviation policy. There are indications that producers' incomes have, indeed, increased since last year. To obtain systematic, quantitative information concerning the impact of policy changes on prices and rural household welfare, the government will implement a survey of rural households in cashew-producing areas, with a special focus on women. The design phase has been completed with World Bank support. A baseline survey will be carried out by the Ministry of Agriculture in March 1997, and initial analysis will be completed by June 1997. This will be followed by periodic monitoring surveys.

CFM Restructuring

42. The Government is determined to improve the performance of its railways and ports systems both to remove constraints to the movement of goods and people and to fully realize the foreign exchange earnings potential of the transit corridors. We can thus reasonably expect that, following the restructuring plan described below, CFM annual gross revenue will increase from the current $70 million to perhaps $200 million after just a few years.

43. Several key actions have been undertaken during the last two years with a view to commercializing the operations of CFM and to establishing it on a sound financial footing. To give it more autonomy, CFM was converted into a public company in January 1995. Consequently, a Performance Contract for 1996-98 with Government, which specified key financial and operating targets as well as a corporate strategy, has been signed. The contract already serves as a means of coordination and control. In addition, concession agreements have been signed for a number of port terminals in Maputo and Beira, and are beginning to function effectively.

44. Yet, CFM is far from realizing its full potential. Serious problems remain with respect to organization, staffing, and infrastructure. To overcome these constraints and to ensure the desired development of the ports and rail systems, CFM has formulated and Government has approved a Restructuring Plan. Several components are already under implementation. The plan comprises three main components: Rationalization, Revitalization, and Privatization (concessioning). The plans will be substantially implemented by the end of 1998.

45. **Rationalization.** The CFM headquarters will be restructured to function as a holding company and to focus on key corporate functions such as developing new business,

promoting private participation through concessions, monitoring concession agreement, safety regulation, corporate finance, and human resource development. The new structure will be lean and thin. The matter regarding staff rationalization is being studied both by consultants and CFM headquarters under the restructuring plan. The zonal CFMs will be converted into autonomous companies. Fully establishing this new structure will take about a year.

46. Increasing staff productivity will imply early retirement, retrenchment of staff as well as recruitment of qualified personnel, training, and a rationalized salary structure. Implementation of the staff rationalization plan could take up to four years.

47. The CFM assets revaluation, a necessary condition for improving their management, will be completed by March 1997.

48. **Revitalization.** The critical areas of CFM requiring rehabilitation will be identified and detailed reports will be prepared to serve as a basis for the performance improvement plan, including the financial and operating targets that have been incorporated in the contract program that has been signed between the Government and CFM.

49. **Private Concessioning.** All remaining port services and rail systems will be concessioned in the course of the next three years on the basis of recommendations from consultants and as approved by Government. This work is underway. Concessioning of port services and terminals will ensure that our ports: (i) respond to the interests of Mozambique and all its regional partners; and (ii) operate in competition to other ports in the region (as opposed to being subordinate to specific interest groups).

50. Inadequate dredging of the approach channels at Maputo and Beira is a major constraint to growth of port traffic. The Government will therefore take necessary measures to modify the legal framework which currently requires all dredging to be undertaken by or through Empresa Moçambicana de Dragagens, E.P. Emodraga, and open this activity to competition no later than mid-1998; and develop appropriate mechanisms for full recovery of the costs of dredging from port users.

51. The Government will closely monitor the implementation of the Restructuring Plan and ensure that there is no slippage. In particular: (i) the Government will inform the consultants of its preferred choice of concessioning options and will authorize them to commence the marketing campaign for pre-qualification of bidders by the end of December 1996; (ii) the bids for the concession of the port services, remaining port terminals (general cargo and ferro-chrome), and railway lines (Ressano Garcia, Goba, Limpopo) of CFM- South will be issued by the end of March 1997; and (iii) the evaluation of all these bids will be completed before September 1997.

52. In view of the progress made on the process of reform of the Mozambican economy under previous adjustment operations and the proposed program as presented in this letter, the

Government requests the favorable consideration of the Third Economic Recovery Credit. It is the Government's intention to implement this far reaching set of measures with technical and administrative efficiency. I believe this operation will help to more firmly establish the conditions for sustained economic growth, through the development of the private sector and improved macroeconomic stabilization. I believe also that it will contribute to raising the incomes of large numbers of men and women in our rural areas.

Yours sincerely,

Tomaz A. Salomão
Minister of Planning and Finance
Republic of Mozambique

IMAGING

Report No: P- 7043 MOZ
Type: MDR