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Republic of Mozambique: Ex Post Assessment of Mozambique's Performance Under Fund-Supported Programs

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REPUBLIC OF MOZAMBIQUE

Ex Post Assessment of Mozambique's Performance Under Fund–Supported Programs

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November 21, 2003

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EXECUTIVE SUMMARY

- **Mozambique completed satisfactorily four Fund-supported programs during the period 1987-03.** These programs were instrumental in helping the country move from a centrally planned to a market based economy, achieving macroeconomic stability, and substantially reducing the debt burden. Real GDP growth averaged close to 7 percent a year over this period, the international reserves position was strengthened, the NPV of the public external debt was reduced from over 500 percent of exports at end-1998 to below 100 percent, and significant progress was made in implementing "first generation reforms." In addition, the share of the population living in absolute poverty declined from an estimated 80 percent in 1989–94 to 69 percent in 1997, and advances have been made in recent years toward achieving the objectives specified in the PARPA (Mozambique's PRSP). Political stability and the authorities' strong commitment to structural reform were essential factors in the process.

- **Although the economy responded positively to the reforms of the last fifteen years, important weaknesses and vulnerabilities remain.** Macroeconomic stability needs to be consolidated, and a "second generation" of reforms is required to sustain growth and further reduce poverty. Government revenue needs to be further strengthened and expenditure efficiency improved to provide room for higher spending on priority sectors. Monetary management should be improved to control inflation, which is still relatively high and volatile, and external competitiveness should be enhanced through structural measures to encourage export diversification.

- **Mozambique's prospects for broadening and sustaining growth depend critically on removing a number of remaining obstacles to private sector development, including in the financial sector.** In particular, the cost of doing business is still high, labor rigidities hinder external competitiveness, and there is a need to improve the country's infrastructure.

- **The financial sector has shown weaknesses in recent years, leading to costly recapitalizations of banking institutions with public funds.** A still limited supervisory capacity, weak accounting practices, and an inefficient judicial system have been at the root of the problem. Addressing these structural issues is crucial to improve the lending environment and facilitate access to bank credit.

- **Mozambique faces capacity constraints in several areas.** Fund technical assistance has been most successful when the authorities have shown a strong ownership of reforms, coordination with donors has been close, and support has been provided without interruption for several years, as in the program to strengthen the tax system.

- **The authorities have expressed a strong interest in continuing Fund support to address the unfinished agenda of structural reforms.** The staff believes that a successor PRGF program—albeit with low access—would be justified on the grounds that (i) a considerable part of the reform agenda falls into the Fund's core areas of responsibility; (ii) other multilateral institutions and bilateral donors continue to rely on the Fund to assess Mozambique's macroeconomic performance; and (iii) a new program would help garner support for politically difficult reforms.

EXPOST ASSESSMENT OF MOZAMBIQUE'S PERFORMANCE UNDER FUND–SUPPORTED PROGRAMS

I. INTRODUCTION

1. The purpose of this paper is to assess Mozambique's progress in implementing its program of economic reform under Fund–supported programs since 1987 and to draw lessons for a possible successor arrangement.[1]

2. Mozambique's good record of economic policies and structural reforms earned the country generous support from the donor community and debt relief under the Initiative for Heavily Indebted Poor Countries (HIPC Initiative). The country enjoys macroeconomic stability, its growth performance has been strong, and its debt burden is sustainable. Moreover, some indicators suggest that progress is being made toward achieving the objectives set in 2001 under the PARPA (Mozambique's Poverty Reduction Strategy Paper (PRSP)), particularly in the areas of health and education. However, Mozambique remains highly dependent on external aid and faces the challenge of addressing a reform agenda whose completion is essential to broaden and sustain growth.

3. The paper is divided into six sections. Section II presents a brief description of Mozambique's situation before Fund involvement. Section III describes the main developments under Fund–supported programs and evaluates the country's performance under those programs. Section IV discusses the lessons learned from Fund involvement and Mozambique's policy challenges for the medium term. Section V focuses on aid effectiveness, and Section VI discusses the possible continuation of Fund support under a successor arrangement. A chronology of the main policy measures adopted since 1987 is presented in the Annex.

II. THE SITUATION BEFORE FUND INVOLVEMENT

4. After Mozambique gained independence from Portugal in 1975, the authorities moved toward establishing a centrally planned economy.

5. Civil war and the second oil price increase, together with inappropriate policies, contributed gradually to a pronounced economic deterioration. Developments in the public finances in the early to mid–1980s were characterized by a shrinking tax base and pressures

[1] This paper was prepared by a staff team comprising Messrs. Di Tata (Head), Engelke, and Manoel, and Ms. Mashinkila (all AFR), Mr. Frécaut (MFD), Mr. Kim (PDR), and Mr. Moissinac (FAD). The team was assisted by Mr. Perone, the Fund's Resident Representative in Mozambique.

on defense spending. A complex and extensive system of price controls and import licensing was introduced, and the state took control of a large part of the industrial sector. By 1985, real GDP had fallen by about one–fourth relative to its 1981 level, exports and imports had dropped sharply, and external debt–service obligations had exceeded 200 percent of exports of goods and services.

III. Main Developments Under Fund–Supported Programs

6. Since 1987, Mozambique has had four Fund–supported programs, including one Structural Adjustment Facility (SAF) arrangement, two Enhanced Structural Adjustment Facility (ESAF) arrangements, and one Poverty Reduction and Growth Facility (PRGF) arrangement. This section provides a brief description of developments under these programs. To facilitate the analysis, the period 1987–2002 was divided into three stages: the early phase of Fund support (1987–92), a second phase characterized by a deepening of liberalization and structural reforms (1993–98), and a third phase involving consolidation of "first generation reforms" and adoption of the PARPA.

A. The Early Phase of Fund Support (1987–92): Reduction of Macroeconomic Imbalances and Establishment of the Foundations of a Market–Based Economy

7. **Early Fund involvement focused on reducing macroeconomic imbalances, restoring growth, and establishing the foundations of a market–based economy.** Fund–supported programs included a SAF arrangement (1987–89) and the first three years of the first ESAF arrangement (mid–1990 through 1992), which was subsequently extended.

8. **Program design concentrated on reestablishing a system of market–determined prices as a precondition for economic stabilization and output recovery**. Measures in 1987–88 included major adjustments of the official exchange rate and a progressive reduction in the number of commodities subject to price controls. The import licensing scheme was phased out, and the export retention scheme was abolished in 1992. A major tariff reform was implemented in 1991 that eliminated specific import duties and simplified the tariff schedule, establishing a maximum tariff rate of 35 percent.

9. **On the fiscal front, the major objectives were to improve revenue mobilization and contain recurrent expenditure.** The overall deficit after grants, however, increased until 1990, owing to higher outlays related to the restructuring of enterprises before privatization, and to expenditures on defense and infrastructure development (Table 1). A large number of small and medium–sized enterprises were privatized or put under concession contracts, but the privatization of large enterprises was delayed.

10. **Broad money growth was gradually controlled by limiting bank financing of the government and restraining the expansion of credit through the commercial banking**

arm of the Bank of Mozambique (BoM). In addition, the interest rate structure was simplified by phasing out the system of preferential rates for specific activities. Institutional reform in the monetary and financial areas focused on the separation of the commercial and central banking functions of the BoM. This was accompanied by the restructuring and cleanup of the commercial arm of the BoM, which was renamed Banco Comercial de Moçambique (BCM) in 1992.

11. **The economy responded positively to the numerous reforms introduced after 1987, with real GDP attaining an average growth rate of 7 percent a year in 1987–91 (Figure 1), and inflation declining from more than 160 percent in 1987 to below 35 percent in 1991 (Figure 2).** The external current account deficit (after grants) improved moderately to an average of 15 percent of GDP for the period 1987–92, with exports increasing at a rate of 11 percent a year. The debt dynamics, however, remained unsustainable, notwithstanding debt relief granted by official and commercial creditors.

12. **The progress achieved in this period could not be sustained without deeper reforms.** By the end of the period, most industrial and banking assets continued to be owned by the state, there was still a large monetary overhang, and credit allocation continued to be influenced by state preferences. Tax revenue, which had grown in 1988–89 aided by the initial tax reforms and the realignment of prices and the exchange rate, weakened in the early 1990s, largely because of problems in customs administration and the granting of tariff exemptions. In 1992, real GDP contracted sharply because of a severe drought, inflation increased to 55 percent, and the external position deteriorated.

13. **In October 1992, the government and the main rebel group signed a peace agreement calling for free elections within a year and the demobilization of excess military personnel.** The accord put an end to a war that had lasted over 16 years and seriously affected most of the country's productive sectors.

B. Second Phase (1993–98): Deepening of Economic Liberalization and Institutional and Structural Reforms

14. **Fund–supported programs during this period aimed at further liberalizing the exchange and trade systems, reducing fiscal imbalances, and diminishing the role of the state in the economy.** In addition, reforms in the financial sector focused on developing the institutional framework for commercial banking and establishing a supervisory regime. Programs included the final part of the first ESAF arrangement (1993–95) and the second ESAF arrangement (1996 through mid–1999).

15. **In 1993, the authorities freed all prices (with the exception of products subject to monopolistic conditions) and moved to a market–determined exchange rate system.** Subsequently, the BoM liberalized certain current account transactions, gradually eliminated export surrender requirements, and established an interbank foreign exchange market.

16. **Fiscal policy sought to reduce the deficit after grants and the domestic financing of the government.** In December 1993, the authorities introduced a tax reform aimed at rationalizing the system. Measures were also taken to revamp customs administration: ad hoc tariff exemptions were eliminated, customs controls were strengthened, and in late 1996 a customs management contract was signed with the Crown Agents. Government outlays were reduced over the period by curtailing subsidies and sharply reducing military spending. In 1994, however, expenditure increased markedly on account of the demobilization and the holding of the first multiparty elections.

17. **Monetary management moved gradually from a reliance on credit ceilings on individual banks to the use of reserve requirements and, starting in 1997, indirect instruments of monetary control.** Interest rates were fully liberalized in 1994, but structural obstacles, including state ownership of the two main banks, prevented them from becoming fully positive in real terms until 1997 (see Figure 2). A bond market developed gradually, and an interbank money market was introduced in 1997.

18. **The number of banking institutions increased markedly over the period.** The government also proceeded with the partial privatization of the BCM and the Banco Popular de Desenvolvimento (BPD), which was renamed Banco Austral (BA). A Financial Institutions Law and a Central Bank Law were passed in 1991, introducing banking supervision rules that were later supplemented by prudential regulations and the introduction of on–site and off–site inspections.

19. **In the trade area, the tariff regime was further simplified by reducing the number of tariff rates from 12 to 5, with the maximum tariff remaining at 35 percent.** Substantial further progress was made on privatization, as state companies accounted for less than one–third of industrial output in 1997, compared with over two–thirds in 1990. Also, a new and more liberal Investment Law was enacted.

20. **The progress made in 1993–98 was commendable.** Real GDP growth averaged 8½ percent a year, inflation was reduced to single digits, and the government was able to resettle about one–third of the population and to demobilize around 80,000 soldiers. The budget deficit after grants was reduced significantly after 1994, and central bank financing of the deficit was virtually eliminated (Table 1 and Figures 3 and 4). Monetary control improved (Figures 5 and 6), competition in the banking system was enhanced, and the role of the government in the economy was reduced substantially. Exports doubled during the period, and the external current account deficit after grants narrowed significantly (Figures 7 and 8). At the same time, the international reserves position strengthened substantially (Figure 9). An important development toward the end of the period was the large increase in foreign investment in megaprojects, including the Cahora Bassa hydroelectric power rehabilitation project and the MOZAL aluminum smelter.

21. **Notwithstanding these advances, a number of structural problems remained.** Although a basic supervisory framework for the banking system had been put in place, capacity to implement effectively the new regulations was lacking. Moreover, the two main

banks remained subject to political interference, and an inefficient judicial system translated into a rising level of nonperforming loans (especially for the BCM and BA) and high lending rates (Figure 10).

C. Third Phase (1999–2002): Consolidation of "First Generation Reforms" and the PARPA [2]

22. **The main objectives of the government's program for 1999–2002, which was supported by the PRGF arrangement, were to sustain growth and low inflation, with increased emphasis on combating poverty by improving the delivery of social services, in line with the PARPA.** The program's structural objectives included strengthening government revenue, enhancing the efficiency and transparency of government operations, improving bank supervision, and initiating the reform of the judicial system.

23. **Substantive progress was made in the area of revenue mobilization with technical assistance from the Fund and several donors.** Main reforms included (i) the introduction of the Value Added Tax (VAT) in 1999; (ii) the implementation of a new income tax, starting in 2003; and (iii) approval in 2002 of a new and more transparent fiscal incentives code. In addition, further reforms were carried out in the customs office, controls over large taxpayers were strengthened, and preparatory measures were adopted for the establishment of a Central Revenue Authority (CRA). Steps were also taken to increase the transparency of budgetary operations. The government started to publish quarterly budget execution reports, and a new public financial administration law was approved that envisaged the implementation of a modern financial administration system (SISTAFE).

24. **Regarding the financial sector, following approval of a revised Financial Institutions Law, actions were taken to strengthen on– and off–site inspections and the information provided by financial institutions.** However, liquidity and solvency problems in the BCM and BA surfaced in 2000, leading to recapitalization operations and the reprivatization of the BA in 2001.

25. **The import tariff structure was further liberalized in 1999 and 2003 by reducing the maximum tariff rate to 30 percent and 25 percent, respectively, with the average tariff rate declining to about 13 percent.** In 1999, however, the export tax on unprocessed cashew nuts and the variable import surcharge on sugar were raised to support the rehabilitation of the cashew and sugar industries.

26. **Macroeconomic developments during the program were broadly favorable.** Real GDP growth averaged about 7½ percent a year in 1999–2002, despite the devastating floods

[2] "First generation reforms" are defined as including those reforms designed to restore basic equilibrium and make markets work more efficiently, including pricing, exchange rate, interest rate, tax, and expenditure reforms, and the establishment of basic market institutions.

that hit the country in 2000 (see Table 2 and Figure 1). Problems in the banking system and exogenous factors, however, undermined the central bank's ability to contain inflation. After peaking at 22 percent in 2001, inflation declined in 2002 in response to a tighter monetary stance, but the drought contributed to an increase to 14 percent in September 2003 (see Figure 2).

27. **Government revenue as a share of GDP increased steadily from 12 percent in 1999 to 14.2 percent in 2002 (see Table 1 and Figure 4).** The fiscal deficit widened in 2000–01, owing to the impact of bank restructuring operations and the cost of reconstruction after the floods, but it is expected to decline in 2003 (see Figure 3). The external current account deficit rose to 12–18 percent of GDP in 1999–2002, in line with larger inflows of private capital associated with the megaprojects (see Figure 7). Total exports more than doubled over the period, reflecting a substantial increase in megaproject exports (see Figure 8). Following the achievement of the completion point under the HIPC Initiative in 1999, the Net Present Value (NPV) of the external public debt relative to exports declined from 550 percent at end–1998 to 92 percent at end–2002 (Figure 11).[3]

IV. Main Lessons and Policy Challenges for the Medium Term

28. **The government's strong commitment to prudent macroeconomic policies and to the implementation of structural reforms has led to a remarkable improvement in economic performance since 1987**. Real GDP growth averaged 6.7 percent a year in 1987–2002 (with per capita real GDP growth averaging by 4½ percent a year), inflation was reduced markedly, and international reserves rose to adequate levels. These achievements were facilitated by a stable political situation and the consolidation of the democratic system, with presidential elections being held within the normal five–year cycle since 1994. Table 3 summarizes key achievements over the last fifteen years by comparing the situation before and after the Fund-supported programs. A brief evaluation of compliance with the programs' quantitative and structural performance criteria and of recent efforts to streamline conditionality is provided in the box below.

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[3] Since 1984, Mozambique received seven successive debt reschedulings and one deferral from Paris Club creditors for a total amount of US$7.2 billion. Paris Club debt relief evolved from nonconcessional terms (1984,1987) to Toronto terms (1990), to London terms (1993), to Lyon terms (1996,1999), and to Cologne terms (2001). Mozambique also benefited from debt relief provided by multilaterals (including the Fund, IDA, and the African Development Bank) and some non-Paris Club creditors. Despite recurrent debt reschedulings, Mozambique's debt dynamics remained unsustainable until the country benefited from the HIPC Initiative and the enhanced HIPC Initiative, which provided debt relief of over US$2 billion in NPV terms. This relief reduced Mozambique's public external debt by more than 70 percent, resulting in a sharp decline in the ratio of the NPV of public external debt to exports from 550 percent at end-1998 to 92 percent at end-2002 (Figure 11).

Evaluation of Compliance with the Programs' Quantitative and Structural Performance Criteria and Recent Efforts to Streamline Conditionality

Economic performance under the four Fund–supported programs was broadly satisfactory, and most quantitative performance criteria and benchmarks, as well as structural performance criteria, were observed. There were some slippages, however. Under the SAF arrangement, the privatization of enterprises and the simplification of the interest rate structure experienced some delays, and the unification of the official and parallel exchange rates was not fully achieved. Moreover, in 1992, under the first ESAF arrangement, the quantitative performance criterion on the net domestic assets of the central bank and the structural performance criterion on the maintenance of positive real interest rates by year's end were not observed, and in 1993–94 the negotiations on the additional annual arrangement were delayed because of a major inflationary upswing associated with difficulties at the BCM.

Under the second ESAF arrangement, four waivers were requested for the nonobservance of quantitative and structural performance criteria relating to (i) brief delays in the signing of a contract for the private management of customs; (ii) the incurrence of small payments arrears to multilateral institutions, including the Fund (1996); (iii) the nonobservance of monetary ceilings (1997); and (iv) the delayed computerization of four customs posts.

Under the PRGF arrangement, the September 1999 quantitative performance criteria on net domestic assets and net international reserves, as well as the benchmark for government revenue, were not observed by small margins. Also, customs legislation that constituted a structural performance criterion was delayed. In addition, the benchmark on reserve money growth for 2001 was missed, owing to difficulties in the financial sector (the BA and BCM), and the performance criterion on the domestic primary deficit for end–June 2002 was exceeded by a small margin. Vulnerabilities at Banco Internacional de Moçambique (BIM) constituted a key factor behind delays in completing the fifth review under the arrangement.

Mozambique provides a good example of efforts to streamline conditionality under Fund-supported programs. Under the program covered by the PRGF arrangement, the number of structural performance criteria was halved at the time of the first review and remained at 2 or less under subsequent reviews, with the number of structural benchmarks falling during the course of the arrangement. Moreover, the range of areas subject to structural conditionality narrowed considerably. Specifically, starting with the third review, conditionality was limited to fiscal issues and the financial sector. This implied a significant streamlining relative to previous programs, which included conditionality in other areas, such as privatization and trade reform.

29. **The progress that has been achieved, however, has required considerable time owing to a number of factors.** In particular, the low starting point of the reform process, characterized by a very difficult post–conflict situation and the poor state of the economy, as well as serious capacity constraints, have been major limiting factors.

30. **Looking ahead, the government's major challenge is not only to sustain growth but also to broaden it in order to reduce poverty**. In recent years, growth has been stimulated by foreign investment flows in large–scale projects and the recovery of the agricultural sector following the floods in 2000. However, the linkages of the megaprojects with the domestic economy are limited, and the performance of the agriculture–based family sector has been less buoyant. Broadening and sustaining growth requires the implementation of a "second generation" of structural reforms to increase total factor productivity and encourage private investment in sectors with high growth potential, such as agriculture, light manufacturing, tourism, transport, and mining.[4]

31. This section discusses the main lessons learned from the four Fund–supported programs and the remaining policy challenges in the macroeconomic and structural areas. During the whole period, Fund-supported programs, together with the authorities' strong responsiveness to Fund advice and technical assistance, were instrumental in facilitating the implementation of reforms and garnering donor support. Moreover, the authorities' ownership of programs improved over time, as demonstrated by the preparation of the PARPA and the adoption of several important reforms in tax policy and public expenditure management in the context of the PRGF arrangement. This section also evaluates the advances made under the PARPA, progress toward achieving the Millennium Development Goals (MDGs), developments in the area of technical assistance, and Fund collaboration with the World Bank.

A. Fiscal Policy

32. **A major objective of successive Fund–supported programs has been fiscal adjustment aimed at avoiding pressures on domestic interest rates arising from domestic financing of the government's deficit, and at reducing the country's medium-term dependence on foreign aid.** Progress in this area, however, has been interrupted at times by the impact of exogenous shocks and weaknesses in the financial sector. In particular, capital expenditure and net lending edged up significantly in 2001–02, owing to the cost of reconstruction after the 2000 floods and large bank restructuring costs.

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[4] "Second generation reforms" are defined as a set of measures needed to enable a country to achieve sustained high-quality growth. They include measures to develop appropriate institutions and frameworks within which markets can operate efficiently, improve governance and transparency, encourage private investment, boost productivity, and reduce poverty.

33. **The authorities' determination, together with uninterrupted technical assistance from the Fund and several donors, has been instrumental in achieving a steady increase in government revenue since 1999.** During this period, reforms have concentrated on simplifying the tax system and broadening the tax base. The VAT introduced in 1999, which was based on a single rate with few exemptions, together with selective excise taxes, allowed for the replacement of a cascading turnover tax and a consumption tax. This was followed in 2002 by the new fiscal incentives code, which limited the scope of permissible exemptions, and by the new codes for corporate and personal income taxes, which replaced a complex system of five taxes on income whose base had been eroded by generous exemptions and deductions.

34. **Customs reform consisted of the hiring of a foreign private firm to manage customs, together with successive reductions in both tariff rates and the number of exemptions.** Main reforms included the modernization and integration of a large part of the customs legislation into a unified body, retrenchment of redundant staff, rationalization of the pay structure, and progress in computerizing customs procedures. There were, however, some delays in the process related to capacity constraints.

35. **In the future, further efforts are required to increase revenue in order to allow for higher spending on the priority sectors in light of a possible decline in external aid.** In this regard, tax reform efforts should continue to focus on strengthening tax administration by establishing a CRA, improving enforcement procedures, training staff, and creating a tax tribunal. Moreover, particular attention should be given to enhancing capacity in the customs office to ensure the sustainability of reforms after the phasing out of the program managed by the Crown Agents.

36. **Recent Fund–supported programs have allowed for a significant increase in expenditures in priority sectors, in line with the PARPA objectives.** Specifically, total expenditure in PARPA priority sectors rose from 13.3 percent of GDP in 1999 to 18.4 percent in 2002. The higher spending in these sectors has largely been financed by the debt relief obtained under the HIPC Initiative and by an increase in grants and concessional loans after the 2000 floods which might not be sustainable in the future. Substantial efforts should be made in the period ahead to increase efficiency and identify savings in nonpriority areas, in order to allow for a reallocation of expenditure toward social programs and basic infrastructure. In this connection, the public expenditure review (PER) concluded in September 2003 by the World Bank provides several recommendations that are discussed in the staff report for the Article IV consultation.

37. **The government's wage bill has risen markedly in recent years.** Although part of the increase is justified by the hiring of more personnel in priority areas, excessive increases in government wages and a lack of appropriate control over the payroll have been major factors. Strong discipline should be exercised in these areas in order to gradually reverse recent trends and provide room for additional spending in the priority sectors.

38. **Efforts at civil service reform have been of a piecemeal nature and have achieved limited results.** As noted above, the authorities have been unable to contain the growth of the wage bill, and the World Bank PER points to a significant number of "ghost workers" in the education sector. These issues need to be dealt with decisively in the context of the new public sector reform program that is being implemented with World Bank support. In addition, the government should be careful about moving ahead at a fast pace with fiscal decentralization without ensuring first that an adequate institutional, administrative, and financial capacity is in place at the local level.

39. **Fiscal transparency has been an important issue only in the context of recent programs.** Weaknesses in budget execution reporting emerged as a major concern after debt relief under the HIPC Initiative. A 2001 Report on the Observance of Standards and Codes (ROSC) identified several problems, including incomplete budget coverage, inappropriate functional classification, outdated accounting procedures, and deficient controls and audits. In 2002, the authorities adopted a comprehensive approach following the approval of a new Public Financial Management Law that regulates the budget process and calls for the introduction of the SISTAFE. Efforts should continue to consolidate off–budgetary revenue and expenditure into the budget accounts and to implement the SISTAFE, which would permit significant improvements in public expenditure management and reporting. There is also a need to improve the monitoring of contingent liabilities and expand the coverage of the fiscal accounts to include state enterprises and local governments.

B. Monetary Policy

40. **Notwithstanding significant improvements in monetary management, inflation is still unduly high and volatile.** Although this partly reflects the impact of supply shocks, in 1992–94 and 1999–2001 monetary expansion exceeded program targets owing to weaknesses in the banking system and fiscal shocks that were not adequately offset through timely monetary adjustments. In the period ahead, additional actions are necessary to strengthen the BoM's monetary framework. In particular, there is a need to better coordinate central bank sales of foreign exchange with the pace of government expenditures financed with donor support, to enhance the communication of the BoM's goals and actions to the public, to strengthen policy coordination between the BoM and the Ministry of Finance, and to improve the stabilization of the daily supply of bank reserves through open market operations.

41. **Limited attention was paid in the programs to the financial position of the BoM and its accounting practices.** The recent Financial Sector Assessment Program (FSAP) exercise identified the need to strengthen the BoM's independence and its capital, and to review its profit distribution policy. These issues should be tackled in the context of a possible successor arrangement.

C. External Sector Policies

42. **Mozambique has achieved significant progress in strengthening its external position over the past 15 years, but the balance of payments remains subject to major**

risks. As noted above, the country has benefited from debt relief and large–scale foreign investment (see Figure 11). However, the heavy dependence on foreign official assistance (grants and concessional loans) makes it vulnerable to the inherent volatility of these flows (Figure 12).

43. **Mozambique's export performance has been strong, and there is little evidence of aid–related Dutch disease (Figure 13), but the traditional export base (excluding megaproject exports) is still weak and poorly diversified.** Traditional exports are concentrated in a few agricultural products—prawns, cotton, timber, raw cashew nuts, and sugar—whose production is weather sensitive and subject to terms of trade shocks. Moreover, developments in preferential market access granted by developed countries could constitute a source of uncertainty for some of these exports. Stimulating growth in the traditional export sector requires improving competitiveness by increasing flexibility in the labor market, reducing transportation costs, and addressing high lending risks.

44. **The linkages between trade expansion and employment creation have been relatively weak.** Given the small size of economy, foreign direct investment (FDI) flows have focused mainly on export-oriented production, and these investments have been biased toward capital– and natural resource–intensive sectors, such as energy, aluminum smelting, and mining. This bias may reduce the potential benefits of trade and investment liberalization for poverty reduction.

45. **Mozambique's foreign exchange and trade regimes have been liberalized substantially, but the top tariff rate of 25 percent on consumer goods is still high.** In addition, an export tax on unprocessed cashew and a sugar surcharge are currently in place. The staff is of the view that the export tax is distortionary and creates an anti-export bias, and that it undermines the income base of small cashew growers. In the case of sugar, some temporary protection would be acceptable taking into account that the sector's prospects for long-term viability have improved as a result of increased future access to export markets under preferential arrangements. However, a well-defined timeframe for phasing out the surcharge should be specified. Nonetheless, the authorities feel strongly that both the export tax on unprocessed cashew and the sugar surcharge should be maintained over the foreseeable future to rehabilitate both industries, particularly in light of the subsidies provided by competitors, especially in the case of sugar.

D. Financial Sector

46. **The banking system has been a major source of vulnerability in recent Fund–supported programs, resulting in significant fiscal costs.** In the period 2000-02, these costs amounted to over 2 percentage points of GDP a year, reducing the possibility of further increasing the resources available for the priority sectors. In addition, central bank assistance to the distressed banks complicated monetary management. Addressing the remaining weaknesses in the system, including those related to Banco Internacional de Moçambique

(BIM), is of crucial importance in sustaining economic growth and should be a high priority in a possible successor program.[5] The forthcoming diagnostic reviews of the four largest banks constitute an important step taken by the authorities to dispel uncertainties about the condition of the system, and to develop an appropriate strategy to move gradually toward international accounting standards. The authorities should also study options for the government's full exit from the banking system as soon as feasible.

47. **Although the authorities have been able to establish a legal and regulatory framework for banking supervision, enforcement capacity is still weak.** The recent FSAP mission made several recommendations to strengthen supervision and prudential norms in accordance with international accepted practices. The implementation of these recommendations will be supported by technical assistance, including from the Fund.

48. **Access to bank credit remains limited by wide interest rates spreads and high lending rates.** The main reasons for this situation include the dominant position of BIM in the system, the absence of efficient judicial procedures to facilitate loan recovery, and difficulties in obtaining and using collateral. Addressing the remaining weaknesses in BIM should help in this regard. Dealing with the other factors requires the implementation of difficult structural and institutional reforms, including in the judicial system and land tenure regulations.

49. **Microfinance has grown rapidly in recent years, but the industry still accounts for a very small proportion of the credit offered by the banking system.** In addition, its operations are concentrated in the urban areas. A careful review of the regulatory framework is being conducted to facilitate the development of these activities, particularly in the rural sector.

50. **Limited attention was paid under the programs to Mozambique's pension system. The system is dominated by the state pension agency (INSS), which is also the supervisor of the sector.** An important task in this area is to improve transparency and accountability. Moreover, it is essential to complete an actuarial evaluation of the INSS, separate its supervisory and administrative functions, and expand the scope of the regulatory framework to include private pension schemes, which currently are not supervised.

51. **The insurance sector is suffering from lack of transparency and competition.** While some foreign–owned companies recently entered the sector, the state insurance agency (EMOSE) still holds a substantial market share. In the short term, there is a need to improve accounting and disclosure standards in the industry. In the medium term, a strategy should be developed to encourage the healthy growth of private companies in the sector.

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[5] The staff report for the 2003 Article IV consultation provides a description of BIM's current financial situation.

E. Other Structural Policies and Statistical Issues

52. **As noted above, the prospects for broad-based private sector development hinge on improving human capital and addressing an important unfinished agenda of reforms.** In addition to the financial system, this agenda includes key reforms to reduce the amount of red tape and streamline the regulatory framework; expand the country's basic infrastructure; complete the privatization process; reduce labor rigidities (the hiring of expatriates is subject to cumbersome procedures and retrenchment costs are high); and improve governance by increasing transparency, reforming the judicial system, and combating corruption.

53. **Mozambique's judicial system works slowly, and the enforcement of contracts is weak.** With donor support, the government is working on establishing intermediate courts to accelerate the resolution of pending cases and on revising a large body of legislation and procurement regulations. In addition, an Anticorruption Law was recently passed by parliament, and a commission is preparing the regulations of an Anti–Money–Laundering Law. Implementation of these reforms, however, will require substantial efforts to strengthen institutional capacity in the judiciary.

54. **Mozambique's statistical system has weaknesses in several areas, including the national accounts, price, and balance of payments statistics,** that hinder the assessment of macroeconomic developments. Progress so far has been limited, but the government intends to address these weaknesses with technical assistance from the Fund, the World Bank, and donors. Efforts should also be continued to publish metadata in the Fund's data dissemination website in the context of Mozambique's participation in the General Data Dissemination System (GDDS).

F. The Views of the Authorities

55. **In discussing the progress made under Fund–supported programs, the authorities were in broad agreement with the staff.** They highlighted that the country has achieved macroeconomic stability and a sustainable medium–term external position; they also agreed with the staff on the need to remove remaining obstacles to private sector development, including in the financial sector. The authorities noted that both the Fund and the World Bank had played a key role in helping the government implement major reforms, and that the dialogue with Fund staff had become even more productive after the establishment of the resident representative post in Maputo in 1996.

56. **The authorities stressed the importance of raising productivity in agriculture, particularly in the rural family sector,** which accounts for most of the rural population and has a high incidence of poverty. They also underscored the need to continue ongoing efforts to improve public expenditure management, increase efficiency in the public sector, and create an appropriate environment for the development of microfinance activities.

57. **The authorities expressed reservations about the pace of certain structural reforms.** Specifically, they observed that the international institutions had been flexible

regarding reforms in certain areas (e.g., protection for the cashew and sugar industries), but that on occasion their desire to speed up the reform process had generated adverse results that could have been avoided. For instance, pressures to proceed quickly with the privatization of the BCM in 1996 and the BPD in 1997 had led to subsequent problems that could have been prevented if the new owners had been scrutinized more carefully. The authorities also thought that the privatization of state enterprises had been successful, but that insufficient attention had been given to alleviating the social impact on those who had been unemployed during the process.

G. The PARPA and Progress Toward the Millennium Development Goals (MDGs)

58. **Despite the high growth rates recorded over the last fifteen years, Mozambique is still a very poor country.** Several factors explain this situation, including the extremely low initial level of economic and social development associated with the post-conflict situation. Furthermore, only after 1999 the social sectors started to benefit from higher government expenditure owing to debt relief under the HIPC Initiative, a better prioritization of spending under the PARPA, and improved alignment of donor support with the government's objectives. Notwithstanding these difficulties, some advances in reducing poverty and ameliorating social conditions have been made.

59. **The share of the population living in absolute poverty in Mozambique declined from an estimated 80 percent in 1989–94 to 69 percent in 1997, which is the latest year for which a National Household Survey is available.** This outcome was accompanied by a reduction in adult illiteracy and improvements in infant mortality rates. In addition, the first progress report on the implementation of the PARPA, issued by the authorities in February 2003, indicates that progress is being made toward achieving the government's objectives in education (particularly school enrollment for students in grades 1–5 and gender equality) and access to health services (attended births, maternal and infant mortality, and vaccination coverage). However, no information is yet available on the evolution of absolute poverty since 1997. The results of a National Household survey conducted in 2002/2003, which are expected to become available toward the end of the year, will enable an assessment of progress in this area.

60. **Looking ahead, assuming that the current level of external assistance remains broadly unchanged in dollar terms, the prospects for achieving significant progress in reducing poverty hinge on further efforts to strengthen tax collection and to increase the efficiency of government spending, so as to provide adequate resources for the priority sectors.** In particular, special attention should be given to investment in human capital and to developing an appropriate infrastructure in the rural areas (access to water, roads, energy, and telecommunications). Moreover, there is a need to broaden growth to labor-intensive manufacturing, services, and the rural family sector by removing the remaining obstacles to private sector development and enhancing access to credit through microfinance.

61. **The lack of reliable data makes it difficult to assess Mozambique's prospects for achieving several of the MDG targets, which are quite ambitious.** Current estimates suggest, however, that several targets are not likely to be met. Although the country appears to be on track to achieve the MDG target for gender equality in primary education and could meet the target for access to water (at least in rural areas), it is unlikely to meet other education and health MDGs. As noted above, it is not possible at this stage to determine the progress made toward achieving the MDG of halving the proportion of people living below the absolute poverty line by 2015.

62. **Although Mozambique has received large amounts of external assistance (an average of 15 percent of GDP a year over the last five years), reaching the MDGs would require substantial additional resources.** Preliminary projections indicate, however, that external assistance is likely to remain broadly unchanged in dollar terms over the medium term. Moreover, Mozambique has problems of limited absorptive capacity in several areas. Addressing these constraints requires flexibility to accommodate in future fiscal programs additional spending in priority sectors, in case external assistance turns out to be higher than envisaged. In addition, continued efforts are needed to build capacity through an adequate level of investment in human capital and substantial technical support from donors and international organizations, so as to ensure effective use of additional donor support.

63. **The high prevalence of HIV/AIDS constitutes a major challenge for the authorities.** Current estimates indicate that 12 percent of Mozambicans aged between 15 and 49 years are infected, with women more likely to be infected than men. Satisfactory progress has been made under the PARPA in responding to the epidemic through prevention, support, and care activities, including by exceeding the target of 24,000 tests for 2002. However, much remains to be done.

H. Technical Assistance, Collaboration with the World Bank, and PSIAs

64. **The Fund has provided substantial technical assistance to Mozambique over the last 15 years.** On the fiscal side, assistance has focused on the tax system and customs administration, the simplification of the import tariff structure, and, more recently, the introduction of the SISTAFE. Technical support has also been provided to separate the central bank functions of the BoM from its commercial bank functions, strengthen bank supervision and prudential regulations, develop a new system of accounts for the banking sector, improve foreign exchange management and the payments system, and strengthen the statistical system. In addition, missions to diagnose the observance of standards and codes have covered the fiscal, monetary, and statistical areas. Collaboration with the World Bank has been close and productive, particularly in the areas of financial sector reform, trade reform, the tax system, external debt sustainability, the PARPA, and private sector development.

65. **The most successful example of Fund technical assistance has been the program to strengthen the tax system, which started in 1996 and is being supported by the Danish Development Agency (DANIDA) and the Swiss State Secretariat for Economic**

Affairs (SECO). The first phase of the program succeeded in modernizing customs administration, while the second phase supported the introduction of the VAT. The third phase, currently under way, consists of wide–ranging reforms, including preparatory work for establishing the CRA. Several factors have contributed to the success of this program, including the strong commitment of the authorities, close coordination with donors, and uninterrupted support over a number of years. The progress made under other technical assistance programs has been more limited, partly because of insufficient implementation capacity and, possibly, the piecemeal nature of technical support. In close coordination with the World Bank, the African Development Bank, and donors, MFD is preparing a comprehensive program of technical support to assist the government in implementing the FSAP recommendations.

66. **An important lesson from the PRGF arrangement is that well–targeted Poverty and Social Impact Analyses (PSIAs) can help in the formulation of difficult policy decisions.** This was demonstrated by a PSIA financed by the U.K. Department for International Development (DFID) in 2002, which contributed to the debate on the impact of fuel taxes on the poor and facilitated the government's decision to increase substantially these taxes, whose real value had been seriously eroded by inflation.

V. Aid Effectiveness

67. **Mozambique is one of the most aid–dependent countries in the world.** Total grant and concessional loans averaged 33 percent of GDP a year in 1987–95 before declining to 15 percent in 1998–2002. The peak in aid disbursements in the early 1990s was linked to the peace accord and reconstruction.

68. **Although significant progress has been made in aligning donors' programs around the PARPA, several problems still affect aid effectiveness. Particular areas in need of improvement include donor conditionality, aid fragmentation, aid volatility, and donor coordination:**

- A large portion of external aid is tied to the meeting of particular conditions. However, donors sometimes have priorities that do not necessarily match the government's objectives.

- Aid is at times provided in a fragmented manner through numerous projects; this hurts the government's ability to implement coherent programs in certain areas. Managing these projects and complying with reporting requirements constitute major challenges for the authorities, given the weak institutional capacity in some ministries. Also, government officials working on specific projects benefit from significantly better salaries and working conditions than those provided to other civil servants. This leads to a "brain drain" within the government and to major difficulties when projects have been completed.

- Another important problem has been the relatively high volatility of aid disbursements, which affects adversely macroeconomic developments and project execution. This volatility is related to capacity constraints on the recipient side, and, sometimes, to administrative delays on the part of the donors.

- In some instances, project implementation without proper coordination with the government leads to duplication, outputs that do not meet minimum standards, and unexpected recurrent expenditures.

69. **The government and the donor community are taking concrete steps to address the problems mentioned above.** A Development Partners' Group, cochaired by the United Nations Development Program (UNDP) and the World Bank, has been making efforts to enhance interagency coordination and simplify the government's task in dealing with multiple aid partners. Also, there has been a trend among donors to increase the transfer of aid through budget support and sector–wide programs, which has potential advantages over the traditional project–based approach. Moreover, a Group of 11 donors (the so–called G–11), together with the World Bank, has recently developed an initiative to harmonize budgetary support through agreement with the government on a Performance Assessment Framework (PAF) that includes a common set of monitoring indicators. The Fund Resident Representative in Maputo participates regularly in the weekly G–11 meetings, which provide a good opportunity for an open exchange about the donors' main concerns with regard to macroeconomic and structural issues.

VI. Possible Successor Program Under a New PRGF Arrangement

70. **As noted in the staff report for the 2003 Article IV consultation, during the consultation discussions the authorities expressed a strong interest in a successor PRGF arrangement covering the period 2004–06.** The authorities saw such a program as essential to consolidate the fiscal situation, deal with remaining vulnerabilities in the banking system, and address the unfinished agenda of structural reforms that are needed to accelerate private sector development. They also noted that a successor program would serve as a bridge to facilitate continuation of the reform effort during the transition to the new administration that will take office early in 2005.

71. **The staff is of the view that, provided a strong program can be put in place, a successor PRGF arrangement—albeit with low access—is justified** on the grounds that (i) a considerable part of the reform agenda falls under the Fund's core areas of responsibility (fiscal consolidation, tax and public expenditure management, and financial sector, monetary, and exchange rate management); (ii) other multilateral and regional institutions and bilateral donors continue to rely on the Fund to assess Mozambique's macroeconomic performance; and (iii) the program would remain a useful tool to garner support for politically difficult reforms.

Figure 1. Mozambique: Real GDP Growth, 1986-2003
(In percent)

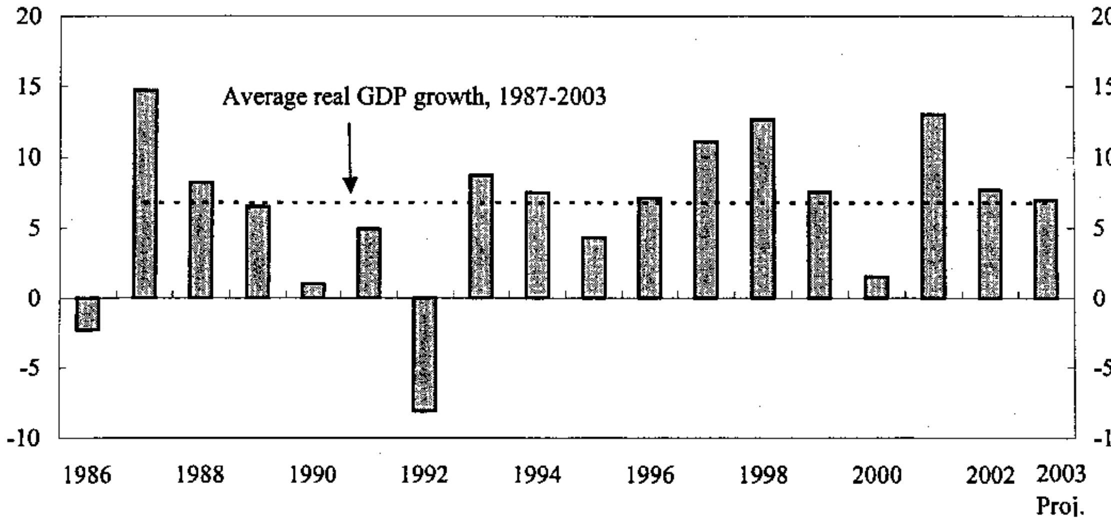
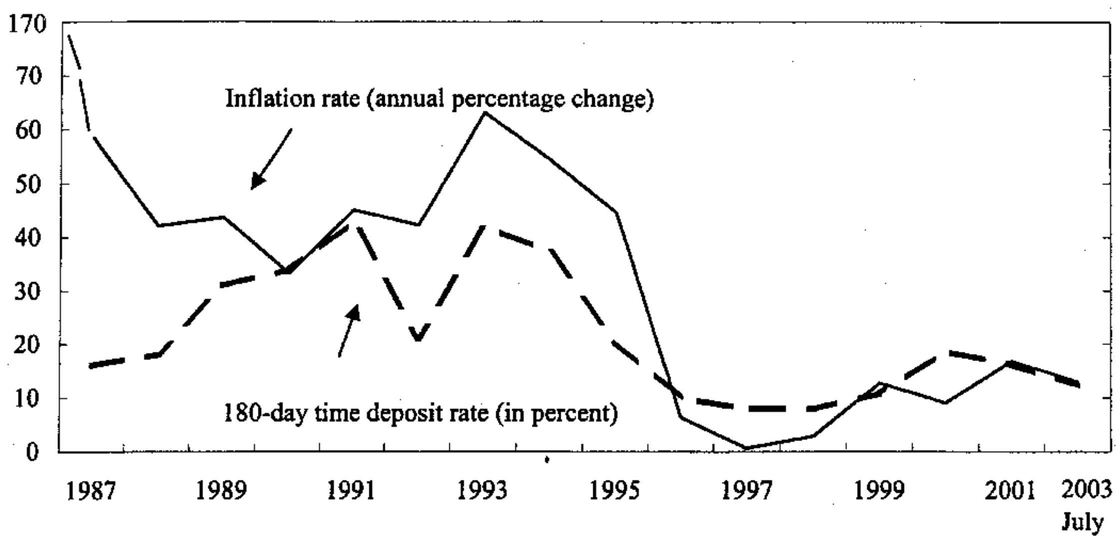


Figure 2. Mozambique: Average Inflation and Time Deposit Rates, 1987- 2003



Sources: Mozambican authorities; and staff estimates.

Figure 3. Mozambique: Fiscal Results, 1989-2003
(In percent of GDP)

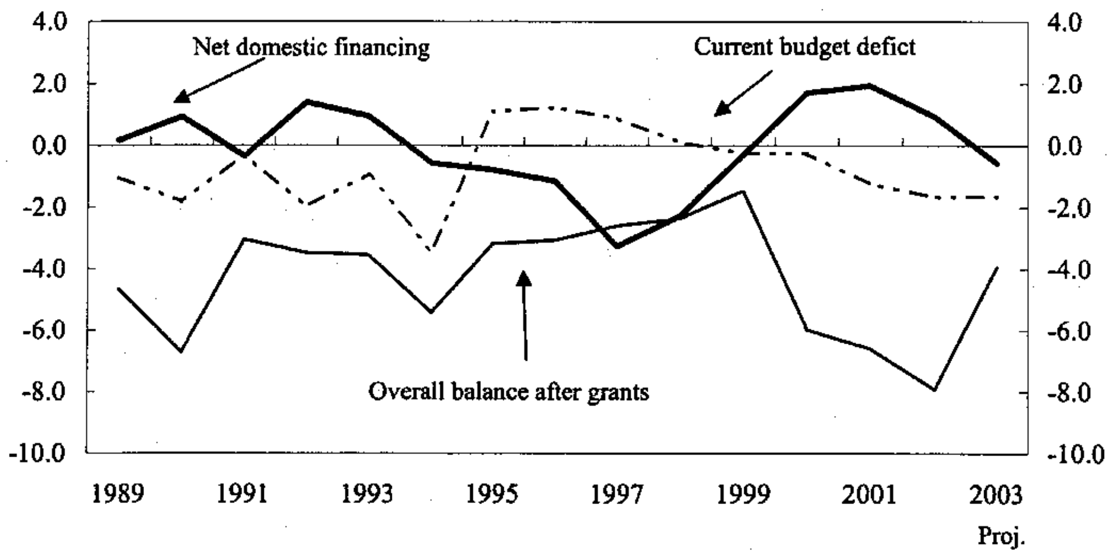
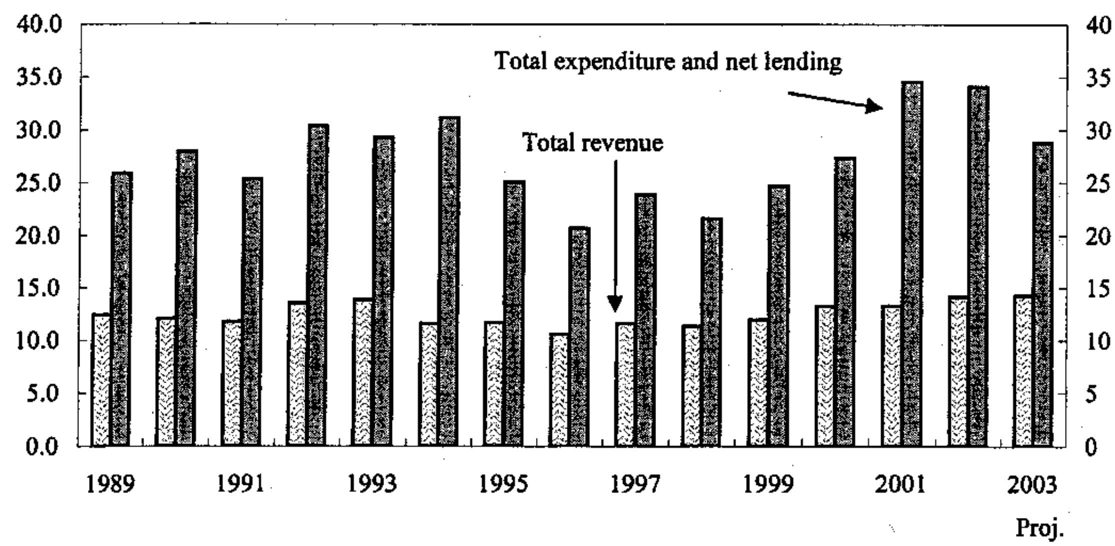


Figure 4. Mozambique: Total Revenue and Expenditure, 1989-2003
(In percent of GDP)



Sources: Mozambican authorities; and staff estimates.

Figure 5. Mozambique: Broad Money (M2) Growth, 1987-2003
(Annual percentage change)

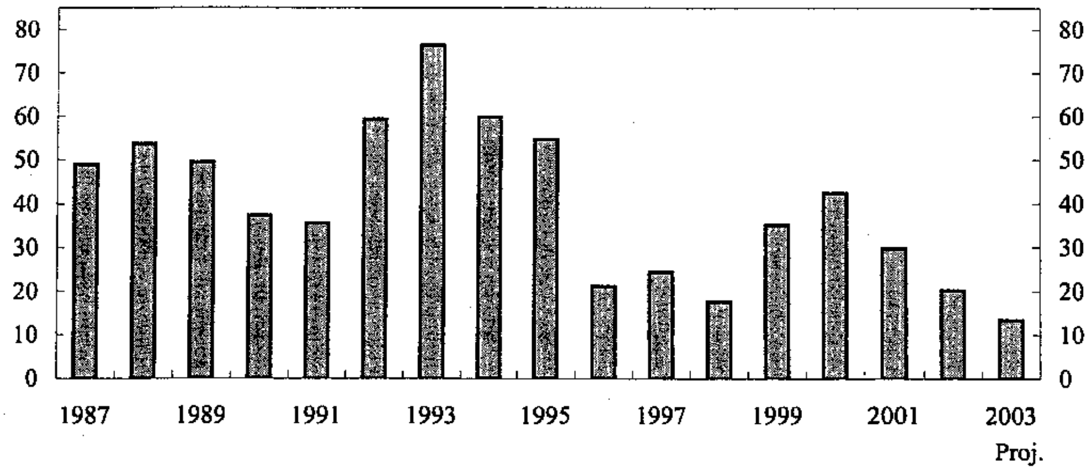
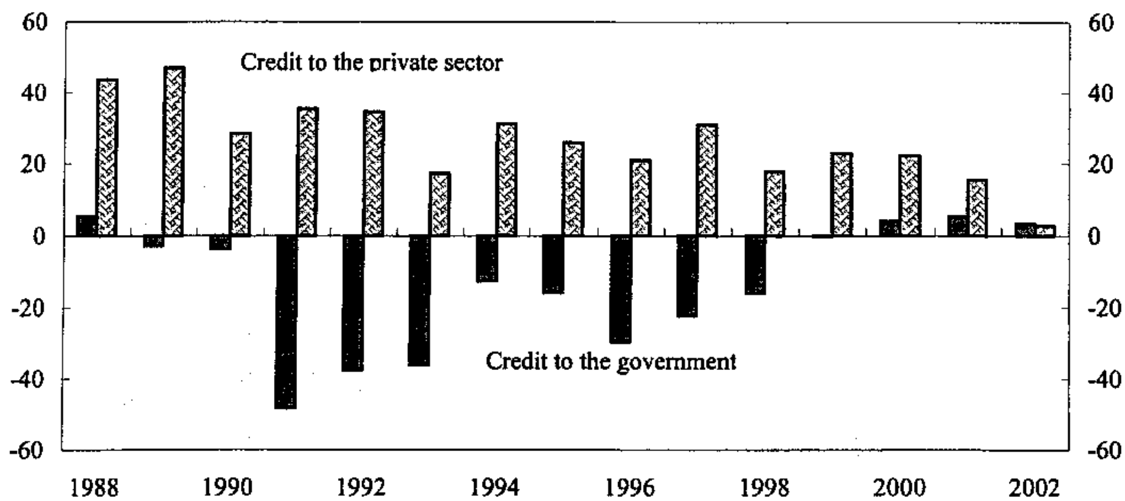


Figure 6. Mozambique: Domestic Credit, 1988-2002
(Annual percentage change relative to M2 at the beginning of the period)



Sources: Mozambican authorities; and staff estimates.

Figure 7. Mozambique: Current Account Deficit After Grants, 1987-2003
(In percent of GDP)

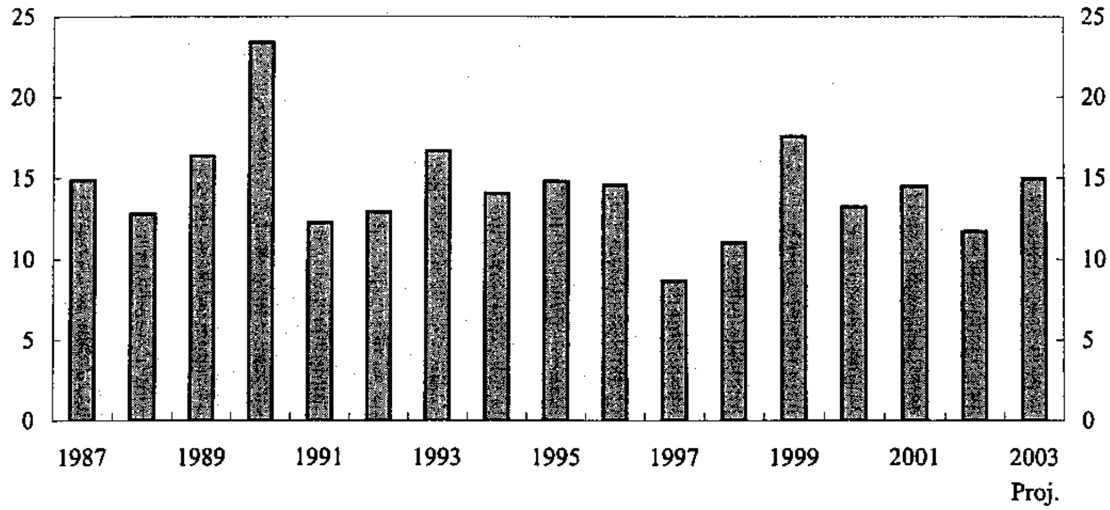
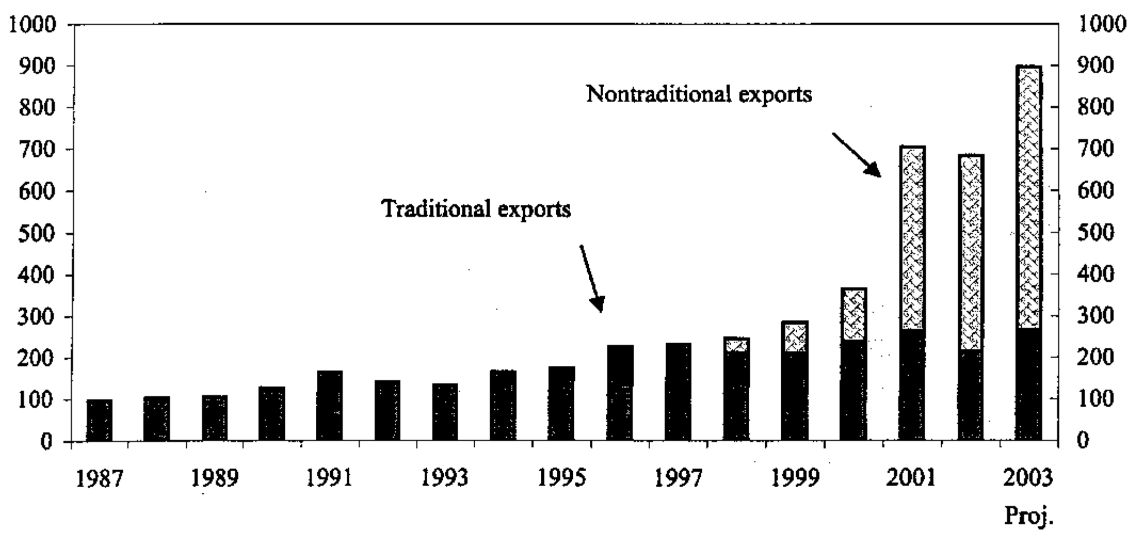


Figure 8. Mozambique: Traditional and Nontraditional Exports, 1987-2003
(In millions of U.S. dollars)



Sources: Mozambican authorities; and staff estimates.

Figure 9. Mozambique: International Reserves, 1991-2003

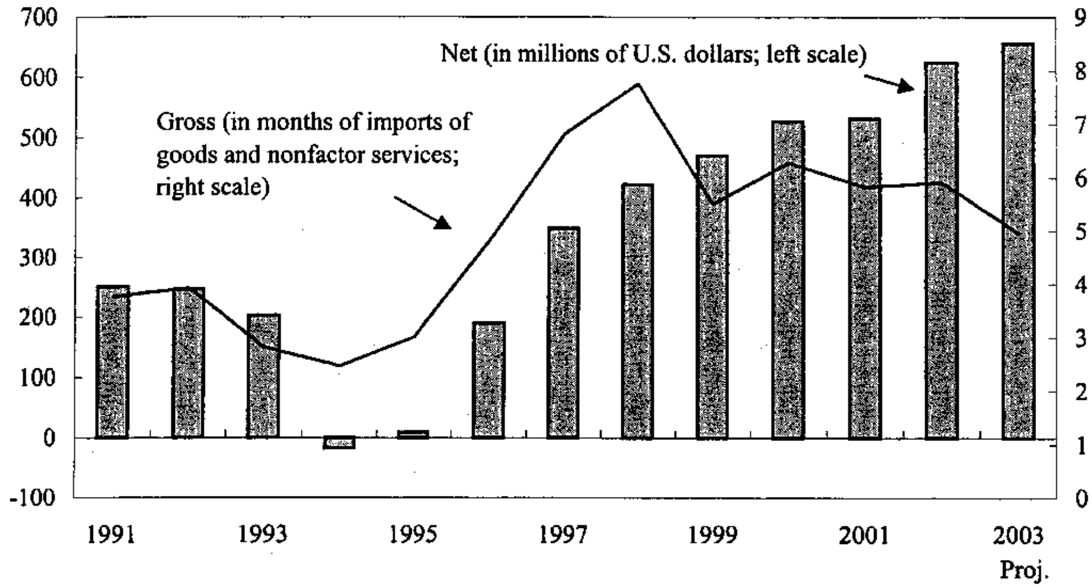
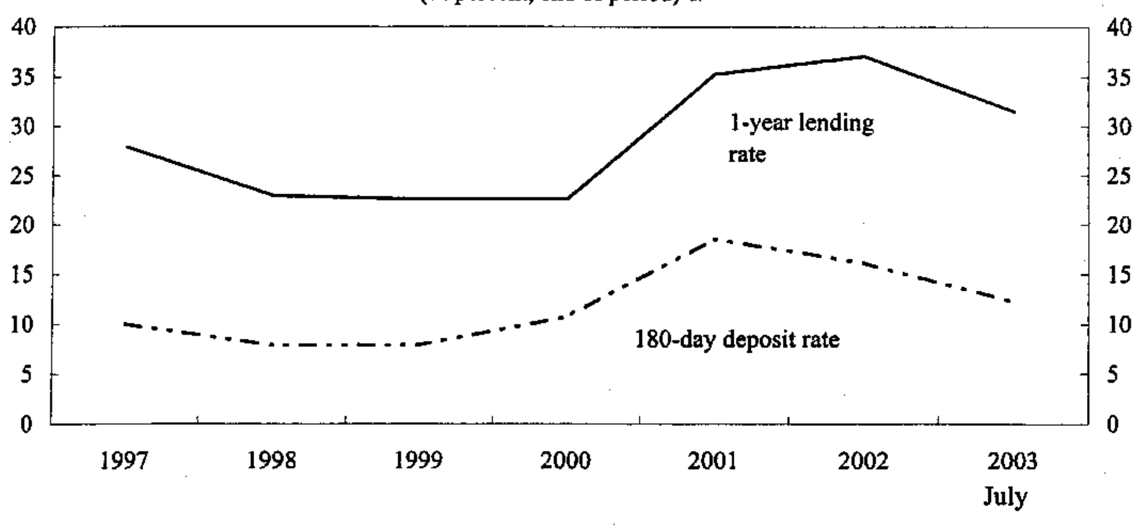


Figure 10. Mozambique: Deposit and Lending Interest Rates, 1997- 2003
(In percent; end of period) 1/



Sources: Mozambican authorities; and staff estimates.

Figure 11. Mozambique: Net Present Value of Public External Debt, 1987-2003
(In percent of exports of goods and nonfactor services)

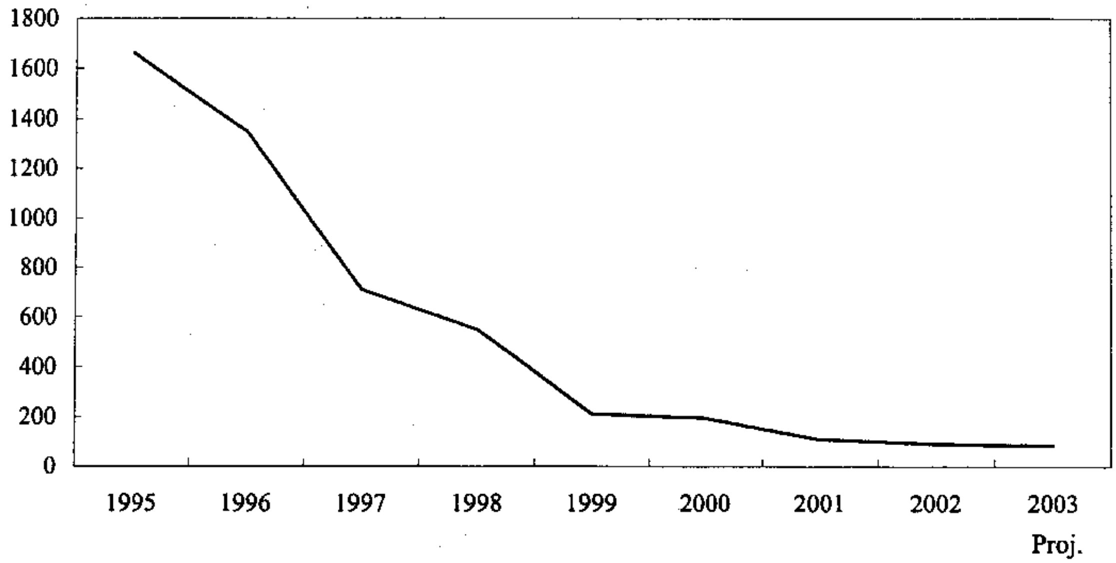
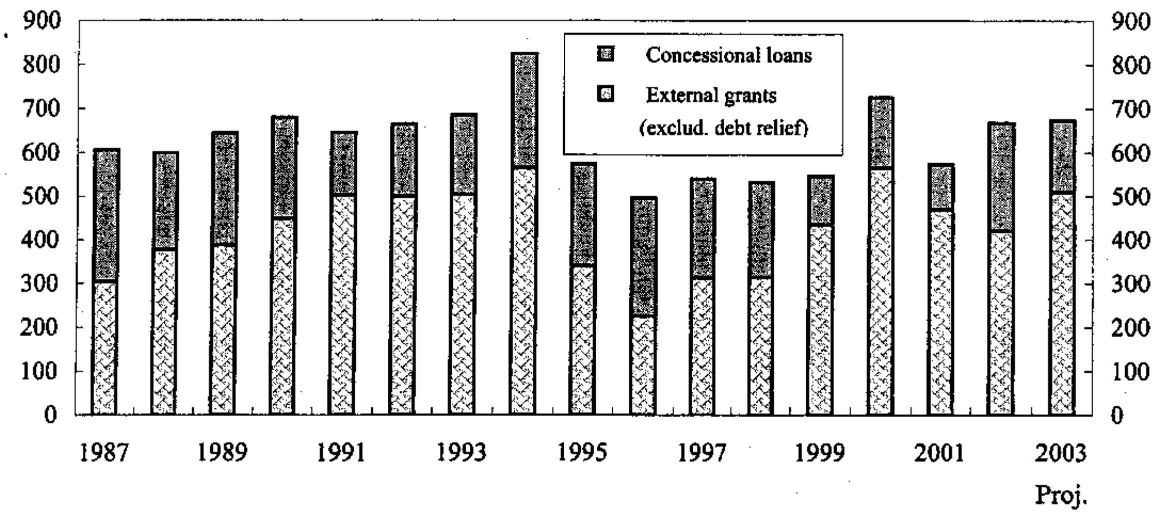
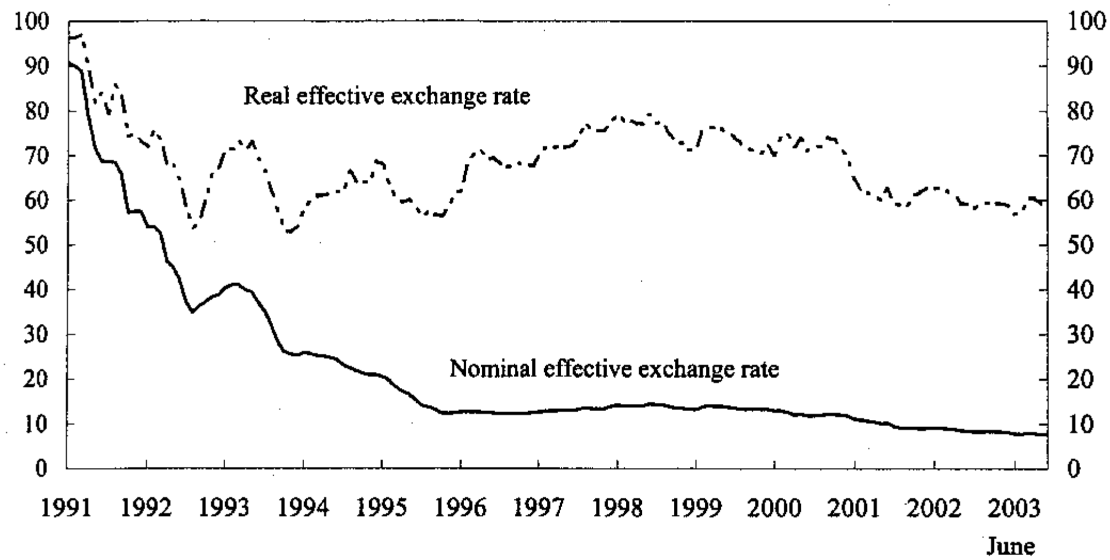


Figure 12. Mozambique: Total Grants and Concessional Loans, 1987-2003.
(In millions of U.S. dollars)



Sources: Mozambican authorities; and staff estimates.

Figure 13. Mozambique: Effective Exchange Rates, January 1992 - June 2003
(1990=100)



Sources: Mozambican authorities; and staff estimates.

Table 1. Mozambique: Government Finances, 1989-2003
(In percent of GDP) 1/

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003 Proj.
Total revenue	12.4	12.1	11.8	13.6	13.9	11.6	11.7	10.6	11.6	11.3	12.0	13.2	13.3	14.2	14.3
Total expenditure and net lending	25.9	27.9	25.3	30.4	29.3	31.2	25.0	20.7	23.9	21.6	24.7	27.3	34.6	34.1	28.7
Current expenditure	13.5	13.9	12.1	15.5	14.8	15.0	10.6	9.4	10.7	11.2	12.2	13.5	14.5	15.8	16.0
Capital expenditure	11.7	13.1	12.3	14.1	13.9	16.1	13.9	11.2	12.1	9.8	11.6	10.6	16.6	14.3	12.7
Net lending	0.7	0.9	1.0	0.8	0.5	0.0	0.5	0.1	1.0	0.6	0.9	3.2	3.4	4.0	0.0
Current budget deficit (current revenue minus current expenditure)	-1.0	-1.8	-0.3	-2.0	-0.9	-3.4	1.1	1.2	0.9	0.1	-0.2	-0.3	-1.2	-1.7	-1.6
Overall balance, before grants	-13.4	-15.9	-13.5	-16.8	-15.4	-19.6	-13.3	-10.1	-11.9	-10.5	-13.2	-14.0	-21.4	-19.7	-14.4
Grants received	8.8	9.2	10.5	13.4	11.8	14.1	10.1	7.0	9.3	8.1	11.7	8.0	14.8	11.8	10.5
Overall balance, after grants	-4.7	-6.7	-3.0	-3.5	-3.5	-5.4	-3.2	-3.1	-2.6	-2.4	-1.5	-6.0	-6.6	-7.9	-3.9
Net external borrowing	4.5	5.8	3.4	2.1	2.6	6.0	4.0	4.2	5.8	4.6	1.8	3.5	3.9	6.3	4.2
Net domestic financing	0.2	0.9	-0.3	1.4	1.0	-0.6	-0.8	-1.1	-3.3	-2.3	-0.3	1.7	1.9	0.9	-0.6

Sources: Mozambican authorities; and staff estimates and projections.

1/ For the period 1989-96, the ratio to GDP differs from those in the original reports because they were recalculated on the basis of a revision of GDP series in 1996.

Table 2. Mozambique: Performance Under the Second ESAF and the PRGF Arrangements, 1996-2002
(In percent of GDP, unless otherwise indicated)

	1996		1997		1998		1999		2000		2001		2002	
	Program	Actual	Program	Actual	Program	Actual	Program	Actual	Program	Actual	Program	Actual	Program	Actual
Basic economic targets														
Real GDP growth (percentage change)	4.0	7.1	6.0	11.3	9.1	12.6	9.7	7.5	3.8	1.5	9.6	13.0	9.0	7.7
Consumer price index (percentage change, end of period)	22.0	16.6	14.0	5.8	6.5	-1.3	5.5	6.2	11.0	11.4	7.0	21.9	8.0	9.1
External current balance after grants	-17.4	-14.6	-11.5	-8.6	-9.2	-11.0	-22.4	-17.5	-17.6	-13.2	-16.3	-14.5	-28.9	-11.7
National accounts														
Gross national savings	11.0	14.0	17.1	14.4	12.5	12.2	13.1	15.1	12.1	23.4	15.3	27.0	28.8	33.0
Gross domestic investment	28.3	28.5	28.6	23.0	21.7	23.2	35.5	32.6	29.7	36.6	31.6	41.5	57.7	44.7
Fiscal targets														
Total revenue	11.8	10.7	11.4	11.6	9.1	11.4	11.8	12.0	12.7	13.2	12.4	13.3	13.0	14.2
Total expenditure and net lending	36.1	20.7	24.0	23.8	17.6	21.6	24.9	24.7	29.1	27.3	35.3	34.7	29.9	33.8
Domestic primary deficit, before grants (excl. bank recap.)	...	...	...	0.7	...	-0.6	-2.6	-3.4	-5.2	-5.1	-6.2	-6.3	-3.4	-3.6
Overall deficit, after grants	-3.2	-3.1	-3.6	-2.6	-2.9	-2.3	-1.0	-1.5	-6.2	-6.0	-8.9	-6.6	-6.7	-7.9
Targets for money and credit aggregates														
Broad money growth (12-month percentage change)	20.1	21.1	19.9	24.4	17.0	17.6	16.5	35.1	34.0	42.4	19.0	29.7	19.2	20.1
Net credit to goverment (12-month percentage change)	-3.4	-8.8	-4.1	-22.3	0.5	-16.0	-11.1	0.0	12.5	4.1	2.4	5.3	7.0	3.3
Net internationl reserves (in millions of U.S. dollars)	...	189.9	...	343.0	371.7	422.0	518.0	465.0	469.0	526.0	526.0	531.0	540.0	625.0
Gross international reserves (in months of imports)	3.5	4.8	5.1	6.8	5.3	7.8	5.0	5.5	5.2	6.3	5.0	5.8	4.4	5.9

Sources: Mozambican authorities; and staff estimates.

Table 3. Mozambique: Key Achievements Under Fund-Supported Programs and Pending Issues

Areas	Situation Before IMF-Supported Programs (1987)	Situation After IMF-Supported Programs (2003)
Overall macroeconomic situation	Macroeconomic imbalances, high inflation, low economic growth	Real GDP growth averaged 6.7 percent a year in 1987-2002; inflation was reduced markedly, and international reserves rose to adequate levels. Growth needs to be broadened and sustained. Inflation is still relatively high and volatile. Balance of payments position is still highly dependent on external aid.
Price system	Complex and extensive system of price controls	Prices have been fully liberalized, with the exception of products subject to monopolistic conditions.
Role of the state and private sector development	Most industrial and commercial assets were owned by the state	A large part of the state enterprises were privatized or put under concession contracts A new and more liberal (private) investment act was approved. Basic infrastructure needs to be improved, including by increasing private sector participation in key sectors (electricity, transport, telecommunications, and water systems). Private sector development should be encouraged by reducing the cost of doing business, addressing labor rigidities, and reforming the judicial system. Public sector reform should be carried out.
Trade	Extensive system of import licensing; export retention scheme in place	Partial trade liberalization in early 1990s. Further liberalization in 1999 and 2003. Top tariff rate was reduced to 25 percent (still high). Ad hoc tariff exemptions were significantly reduced. Export retention scheme was abolished.
Exchange rate policy	Completely managed by the government	Exchange rate determined under a managed float system. Obligations under Article VIII not yet accepted.
External debt	Exceeded 500 percent of exports of goods and services at end-1998	Net present value (NPV) of the external debt relative to exports declined to 92 percent at end-2002 following debt relief under the HIPC Initiative and the enhanced HIPC Initiative. Pending negotiations with bilateral and commercial creditors need to be finalized.

Table 3. Mozambique: Key Achievements Under Fund-Supported Programs and Pending Issues (continued)

Areas	Situation Before IMF-Supported Programs (1987)	Situation After IMF-Supported Programs (2003)
Tax system	Shrinking tax base; cascading tax system with low efficiency and low rate of tax collection; ad hoc fiscal incentives	Tax revenue has increased significantly since 1999. Modern value-added tax (VAT) was introduced. New income tax replaced several taxes on income and profits. New and more transparent fiscal incentives code was adopted. Tax administration should be further strengthened with technical assistance from the Fund and several donors. Efforts should continue to establish the Central Revenue Authority (CRA). An automatic mechanism of adjustment for specific fuel taxes should be introduced.
Customs administration	Weak control and high level of corruption	Customs controls were strengthened. Government outsourced customs management to the Crown Agents. Human resources should be developed to ensure sustainability of reforms and smooth transition to the CRA.
Government expenditure	Pressures on defense spending, weak prioritization of expenditures	Defense spending has been reduced sharply. Expenditure is being prioritized to reduce poverty. The recent increase in the wage bill should be reversed and the government should exercise a stricter control over the payroll.
Fiscal Transparency	Very weak public accounting and budget execution procedures	Transparency of budgetary operations has been increased. Quarterly budget execution reports are being published regularly. New public financial administration law was approved, and a modern financial management administration system (SISTAFE) is being introduced. Pending recommendations in the fiscal Report on Observance of Standards and Codes (ROSC) and the World Bank public expenditure review should be fully implemented, including the SISTAFE.

Table 3. Mozambique: Key Achievements Under Fund-Supported Programs and Pending Issues (concluded)

Areas	Situation Before IMF-Supported Programs (1987)	Situation After IMF-Supported Programs (2003)
Monetary and interest rate policies	Lack of separation of central banking and commercial banking roles of the Bank of Mozambique (BoM); preferential structure of interest rate was in place; credit allocation influenced by state preferences and credit ceilings on individual banks	Bank of Mozambique (BoM) was set up with monetary authority's functions. Interest rate structure was simplified by phasing out the system of preferential interest rates; interest rates were subsequently liberalized. A system of legal reserve requirements was established. Indirect monetary instruments were introduced. A bond market developed, and an interbank money market was introduced. Recommendations of the Financial Sector Assessment Program (FSAP) to improve monetary and exchange rate management should be implemented. Central bank balance sheet should be strengthened.
Banking system	Dominant role of government in the banking system	Government has reduced its participation in the commercial banking area but it should exit fully from the banking system.
	Lack of proper legislation and a prudential framework for the banking system	Financial institutions law was approved. A supervisory regime and rules were established. Prudential regulations and on- and off-site inspections were introduced. Diagnostic reviews of the largest banks should be completed, and international accounting standards (IAS) should be introduced gradually. Remaining vulnerabilities in the financial sector, including in the Banco Internacional de Moçambique (BIM), should be addressed. Bank supervision and prudential regulations should be improved, based on FSAP recommendations. Reforms should be adopted to improve the lending environment and reduce bank spreads. Microfinance activities should be expanded, particularly in rural areas.
Poverty reduction	Lack of a comprehensive framework for poverty reduction	Adoption of the PARPA (Mozambique's poverty reduction strategy paper) as the main instrument for development planning and poverty reduction. Establishment of the Poverty Observatory to ensure participatory monitoring and evaluation of the implementation of the PARPA. Public expenditure efficiency should be improved to allow for additional spending in the social sectors. Efforts should continue to combat HIV/AIDS.

Chronology of Major Policy Measures

1) Structural Adjustment Facility (SAF) arrangement from June 8, 1987 to end-December 1989

2) First Enhanced Structural Adjustment Facility (ESAF) arrangement from June 1, 1990 to end-1995

3) Second ESAF arrangement from June 21, 1996 to June 27, 1999

4) Poverty Reduction and Growth Facility (PRGF) arrangement from June 28, 1999 to June 28, 2003

I. Fiscal Sector

1987
- Government suspends the extension of bank credit to cover losses incurred by public enterprises
- Tax code revised

1988
- Administered prices significantly adjusted and price system simplified

1989
- Government initiates a rolling three-year investment program of core projects to monitor priority expenditures
- Government begins tax administration reforms

1991
- New civil service pay scale introduced to improve the pecuniary element of public salary pay and provide for performance incentives

1993
- Tax reform introduced to streamline the tax system and increase competitiveness of domestic production and exports

1995
- Decision to introduce a value-added tax (VAT) taken
- Government decides to fully restructure customs administration

1997
- Customs management outsourced to Crown Agents

1999
- VAT introduced
- A medium-term expenditure framework is prepared and linked to the annual budget, matching expenditure priorities with resource availability
- a new system of public accounting prepared to improve control and transparency in the execution of the budget

2000
- Government begins publication of quarterly budget execution reports that include detailed information on revenue, expenditures, and financing

2001
- A more detailed economic classification of expenditures introduced, thereby improving accountability

2002
- A new public financial management law, establishing a new financial management system (SISTAFE), promulgated
- A new income tax law and a new fiscal incentive code, simplifying the income tax system and its administration while reducing marginal rates, introduced

II. Monetary and Financial Sector

1987-89
- Administered interest rate structure simplified by reducing the number of specifically entitled economic groups from eight to three

1989
- A new plan of banking accounts introduced to prepare for the separation of the commercial and central banking functions of the BoM

1991
- A law establishing the Bank of Mozambique (BoM) as a central bank only and separating its commercial banking functions from its central banking functions promulgated
- Reserve requirements introduced
- New Financial Institutions Law, laying out the legal basis for banking licensing, supervision, disclosure, and reporting, passed

1992
- Central banking functions and commercial banking functions separated with the establishment of the Banco Comercial de Moçambique (BCM), which assumes the commercial banking functions

1993
- New foreign banks begin operations in Mozambique
- A system of regulations defining prudential norms issued

1994
- All commercial bank interest rates are liberalized
- The BoM sets up a monetary policy committee to coordinate monetary policy with the Ministry of Planning and Finance
- Ceilings on credit by individual banks are replaced by net domestic assets as an instrument to monitor monetary policy
- Payment systems are reformed

1996
- A Portuguese-Mozambican consortium led by Banco Mello takes over 51 percent of the BCM

- Reserve requirements are extended to foreign currency deposits (applied only in late 1999)

1997
- A consortium led by Southern Bank Berhard from Malaysia takes over 60 percent of the Banco Popular de Desenvolvimento (BPD). The bank is renamed Banco Austral (BA)
- Financial Institutions Law revised to strengthen supervision
- A new check law is issued to enhance the payments system

1997-98
- A money market is introduced to manage liquidity through the issuance of treasury bonds (TBs) and bonds of the Banco de Moçambique (TAMs)

1999
- The BoM shifts to indirect monetary instruments of monetary control

2001
- Amalgamated Bank of South Africa (ABSA) takes over 80 percent of the BA
- BCM and Banco International de Moçambique (BIM) merge to form Grupo BIM (government stake is 23 percent)

2003
- Financial Institutions Law (not yet approved by parliament) revised to strengthen the role of the BoM as the main financial market supervision agent

III. External Sector

1987
- Major corrections in exchange rate implemented
- Paris Club debt rescheduled and London Club buyback arrangements made
- Export retention scheme broadened with access for all nontraditional exporters

1988
- Major corrections in the exchange rate implemented

1990
- Paris Club debt rescheduled on Toronto terms through end-1992
- A secondary foreign exchange market is established

1991
- Tariff schedule simplified to five ad valorem rates, with a maximum rate of 35 percent

1992
- Export retention scheme abolished
- Official and secondary foreign exchange markets unified
- Mozambique joins the Southern African Development Community (SADC) as a founding member

1993	• Official and secondary markets reunified (June) • Paris Club debt rescheduled on enhanced terms through end-1994
1995	• Foreign exchange payments for current transactions liberalized up to US$5,000 • Mozambique joins the World Trade Organization (WTO) • Export tax on raw cashew nuts introduced at the tax rate of 26 percent
1996	• New foreign exchange law approved to consolidate the existing legislation and facilitate the compilation of balance of payments statistics • An interbank foreign exchange market is formally created • Tariff structure simplified with a reduction of average tariff rate and tariff dispersion, with the maximum rate set at 35 percent; import tariff exemptions reduced in accordance with the modification of the investment law • Export tax on cashew lowered to 20 percent • Paris Club three-year flow rescheduling made on Naples terms
1997	• Export tax on cashew reduced to 14 percent • Variable import surcharge introduced for sugar • Export surrender requirement abolished • Mozambique ratifies SADC trade protocol
1998	• Decision point reached under the original Initiative for Heavily Indebted Poor Countries (HIPC Initiative), qualifying Mozambique for debt relief amounting to US$1.4 billion in net present value (NPV) terms • Electricity exports resumed and MOZAL aluminum smelter construction started
1999	• Maximum tariff reduced from 35 percent to 30 percent • Export tax on cashew is raised to 18 percent in conjunction with a protective measure offering local processors priority in the purchase of raw nuts • Mozambique reaches the completion point under the original HIPC Initiative, receiving debt relief of US$1.7 billion in NPV terms
2001	• Mozambique reaches the completion point under the enhanced HIPC Initiative, receiving additional debt relief of US$306 million in NPV terms
2003	• Maximum import tariff reduced from 30 percent to 25 percent

IV. Other Economic, Administrative, and Social Reforms

1987	• Most retails prices liberalized • Provisions allowing companies to lay off employees adopted
1988	• The number of goods and services subject to administered prices reduced
1989	• Law approved defining the modalities of public enterprise sales
1991	• The Office for Vulnerable Population (GAPVU) and its safety net program created
1993	• An investment law designed to define rights and obligations; especially of foreign investors, adopted
1994	• The Poverty Alleviation Office (PAU) created
1995	• First private sector development conference held • A Poverty Reduction Strategy formulated
1996	• Prices of bread and wheat flour liberalized as the last staples on the list of administered prices • The National Institute of Statistics created
1997	• First comprehensive household survey concludes that 69.4 percent of the population lives below the poverty line • National Assembly approves new land law clarifying the rights and obligation concerning land use
1999	• About 1,200 enterprises have been privatized since 1987 • First national anti-AIDS/HIV strategy adopted
2000	• Administrative, civil service and judicial system reform initiated
2001	• The first poverty reduction strategy paper (abbreviated PARPA under its Portuguese acronym), linking policy objectives to budgetary allocations adopted
2003	• The Poverty Observatory, providing a forum for the government, donors, academia, and civil society to monitor and discuss PARPA outcomes, introduced