

International Monetary Fund

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Republic of Mozambique: Letter of Intent, Memorandum of Economic and Financial Policies and Technical Memorandum of Understanding

January 24, 2005

The following item is a Letter of Intent of the government of Republic of Mozambique, which describes the policies that Republic of Mozambique intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Republic of Mozambique, is being made available on the IMF website by agreement with the member as a service to users of the [IMF](#) website.

Maputo, January 24, 2005

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

Dear Mr. de Rato,

1. On July 6, 2004, The Executive Board of the IMF approved a three-year arrangement for Mozambique under the Poverty Reduction and Growth Facility (PRGF). In the attached Memorandum of Economic and Financial Policies (MEFP), which supplements the MEFP dated June 4, 2004, the Government of Mozambique describes progress in implementing its program and lays out its policy intentions for 2005. A Technical Memorandum of Understanding on Selected Concepts, Definitions, and Data Reporting Requirements under the program is also attached.
2. As indicated in the MEFP, all the end-June 2004 quantitative performance criteria, as well as the structural performance criteria linked to the second disbursement under the arrangement, were observed. However, the fiscal performance through end-September 2004 was adversely affected by a significant revenue shortfall attributable to a number of factors specified in the memorandum, which has been almost entirely offset by lower spending on goods and services and locally financed capital outlays. As a result, the end-September 2004 indicative target on the domestic primary deficit was missed by a very small margin. On the monetary side, large inflows of private capital have contributed to a larger-than-programmed reserve accumulation, and the end-December 2004 performance criterion on net international reserves is likely to be exceeded. Progress has been made on the structural front, including through the partial implementation of the new financial administration system (SISTAFE) in the Ministry of Planning and Finance, which constitutes an important step toward improving public expenditure management and fiscal transparency.
3. The Government remains committed to strengthening the revenue performance and believes that the policies and measures set out in the attached memorandum are adequate to achieve the objectives of its program, but it is willing to take any further measures that may become appropriate for this purpose. On this basis, the government requests (i) the completion of the first review; and (ii) the disbursement of the second loan under the arrangement.
4. The Government will continue to consult with the Fund on its economic and financial policies, in accordance with the Fund's policies on such consultations, and to provide the Fund with such information as the Fund needs to assess the government's progress in implementing the economic and financial policies described in the MEFP. The second review under the PRGF arrangement will be completed not later than end-June 2005, based on the

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

Sincerely yours,

<p style="text-align: center;">/s/ Luisa Dias Diogo Prime Minister and Minister of Planning and Finance</p>	<p style="text-align: center;">/s/ Adriano Afonso Maleiane Governor Bank of Mozambique</p>
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Attachment

MOZAMBIQUE

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

Maputo, January 24, 2005

I. RECENT DEVELOPMENTS AND PROGRAM IMPLEMENTATION

1. On July 6, 2004, the Executive Board of the International Monetary Fund approved a new arrangement under the Poverty Reduction and Growth Facility (PRGF) to support the government of Mozambique's economic program for the period 2004-06. The government presents this memorandum in support of its request for the second loan disbursement under the PRGF arrangement. The economic and financial policies and related structural reforms described in the memorandum aim to consolidate macroeconomic stability and sustain strong broad-based growth in order to promote employment and further reduce poverty. These policies are consistent with achieving the goals set out in the Plano de Acção Para a Redução da Pobreza Absoluta (PARPA) approved by the government in 2001.
2. Macroeconomic developments in 2004 continued to be broadly favorable. Based on preliminary information, real GDP is estimated to have increased by close to 8 percent for the year as a whole, owing to MOZAL II and the gas pipeline coming into full operation, a significant expansion in the manufacturing and telecommunications sectors, and continued strong performance of services. Inflation declined from 13.8 percent during 2003 to 9.1 percent in 2004, which is below the program's end-year target of 11 percent. All the program's quantitative performance criteria for end-June 2004, as well as the structural performance criteria linked to the second disbursement under the arrangement, were observed (Tables 1 and 2).
3. The government's domestic primary deficit for the first nine months of 2004 (measured from the financing side) turned out marginally higher than programmed. Total revenue was significant below the end-September indicative target owing to higher-than-programmed reimbursements of the value-added tax (VAT), a weaker-than-envisaged performance of customs duties collection attributable in part to the recent appreciation of the metical, and delays incurred by corporations in complying with the payments calendar under the new corporate income tax code. The revenue shortfall was compensated by lower spending on goods and services and locally financed capital outlays. The end-September indicative target on the wage bill was exceeded because of the decision to retain some contractual personnel employed last year in the education sector to help meet the government's objectives in this priority area. The government has continued to adjust domestic petroleum prices on a monthly basis in line with developments in import prices, and has increased specific fuel taxes on a quarterly basis broadly in line with inflation during the previous three months.

4. The end-June 2004 quantitative performance criteria and end-September 2004 indicative targets on the net domestic assets of the Bank of Mozambique (BM) and net international reserves were observed. The indicative targets for base money were exceeded, however, owing to an underestimation of the impact of recent modifications in reserve requirements. Broad money growth declined to about 12 percent in September 2004, significantly below the program's target.

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

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

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

8. Performance regarding the program's structural benchmarks has been mixed (see Table 2). Specifically, (i) the submission of the draft law creating the Central Revenue Authority (ATM) to the assembly was completed in early August 2004, rather than in July; (ii) preparation of the quarterly budget execution report based on the new financial administration system (e-SISTAFE) is now expected to start in the first quarter of 2005, rather than the third quarter of 2004; and (iii) the BM has adopted measures to strengthen the financial position of one small bank but is still studying the resolution strategy for another small institution. The regulations of the new Financial Institutions Law approved in July 2004 and a revised regulatory framework for microfinance activities have already been completed. The government has also begun to implement steps to strengthen the central bank balance sheet in accordance with the legal provisions in the BM Act (see paragraph 22).

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

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

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

II. THE MACROECONOMIC FRAMEWORK FOR 2005-06

12. Following the coming on line of Mozal II and the gas pipeline in 2004, real GDP growth is projected to slow somewhat to 7 to 7.5 percent a year in 2005-06. Inflation (end-of-period) is targeted to decline further to 8.5 percent in 2005 and 7 percent in 2006 as a result

of the maintenance of prudent fiscal and monetary policies. Aid flows (grants and concessional loans) are projected to increase from US\$755 million in 2004 (13.6 percent of GDP) to US\$935 million in 2005 (14.0 percent of GDP).

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

III. THE ECONOMIC PROGRAM FOR 2005

A. Fiscal Policy

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

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

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

17. Noninterest current expenditure would increase from 14.4 percent of GDP in 2004 to 14.8 percent in 2005, reflecting the incorporation into the budget of the expenditures associated with the new revenue from districts and line ministries referred to above. Excluding wage outlays associated with the previously off-budget revenue, the government's wage bill is programmed to decline to 7.4 percent of GDP in 2005, from 7.5 percent in 2004. This projection includes the impact of an increase of close to 10,000 in the number of government employees, most of which is concentrated in the priority sectors. To accommodate such increase within the envisaged target, the average general wage increase for government employees to become effective on April 1, 2005, will be limited to 6.5 percent. Locally financed capital expenditure is programmed to increase relative to its 2004 level. The expenditure projections for 2005 include the impact on the interest bill of servicing the transfer of the BM's external debt liabilities to the government and of the additional domestic debt associated with the issuance of government securities to strengthen the BM's balance sheet. Spending on PARPA priorities is expected to increase from 65.0 percent of total primary expenditure in 2004 to 67.3 percent in 2005.

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

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

B. Monetary and Exchange Rate Policies and the Financial Sector

20. The monetary program for 2005 will seek to achieve a further reduction in end-year inflation to 8.5 percent. In line with anticipated money demand, broad money growth is projected at 14.5 percent in 2005, compared with 12 percent now estimated for 2004. Assuming a decline of US\$25 million in net international reserves, the monetary program

provides room for an increase in credit to the private sector broadly in line with nominal GDP. The central bank will continue to monitor price developments closely and will be ready to sterilize liquidity as needed to achieve the program's inflation objective.

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

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

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

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

C. External Sector Issues

25. No significant changes in the area of trade policy are expected to take place during 2005. Regarding the exchange system, the central bank is preparing a draft of a new foreign exchange law to clarify and improve the existing legislation, which will be submitted to the assembly in the second half of 2005. Following approval of the new law and issuance of certain regulations, the government intends to accept the obligations under Article VIII of the Fund's Articles of Agreement. The government remains committed to lowering the maximum import tariff rate applicable to all trading partners from 25 to 20 percent in 2006.

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

27. During the period of the PRGF-supported program, the government will not impose or intensify restrictions on payments and transfers for current international transactions; will not introduce multiple currency practices; and will not impose or intensify import restrictions for balance of payments reasons. Furthermore, the government will not incur any external payments arrears (continuous performance criterion). In this connection, delays in payments related to cases where debt-restructuring agreements are still pending notwithstanding good faith efforts by the government will not be considered arrears.

D. Other Structural Reforms, Governance, and Poverty Issues

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

29. The government has continued to work on reducing red tape for the registration of new companies in Mozambique. New regulations to simplify inspection procedures were issued earlier this year, one-stop shops for business registration were established in three

locations in recent months, and a new decree streamlining the licensing of commercial activities was issued in mid-September 2004. In addition, the government is considering steps to reduce the time required for customs clearance in order to permit a more fluid transit of goods to and from South Africa. In this regard, preparations have started for establishing a facility to handle road cargo in the Mahotas railroads terminal, but the process has taken more time than envisaged originally. The government believes that, over the medium term, addressing this problem would require the construction of a dry port in Ressano Garcia. To that end, terms of reference for the bidding process are being prepared and consultations have been initiated with the private sector and the South African authorities.

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

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

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

33. The government is conscious of the need to revise land tenure regulations to facilitate the use of land as bank collateral. However, the Council of Ministers has been of the view that, in light of the sensitive nature of the issues involved, any reforms in this area should be preceded by a process of broad consultation with interested parties. In this regard, a draft decree to strengthen property rights in urban areas, including through titling, which was originally expected to be approved by end-July 2004, would need to be reconsidered by the

new administration. The government remains committed to conducting a Poverty and Social Impact Analysis (PSIA) study on land tenure regulations and their implications for accessing bank financing during 2005. Several donors have already expressed interest in providing support for this purpose, and donors and the government are developing the project in the context of the Policy Assessment Framework (PAF) for 2005.

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

IV. SAFEGUARDS ASSESSMENT AND STATISTICAL ISSUES

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

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

37. Following the completion of the National Household Survey in 2003, several studies are being conducted by public and private institutions, including on the determinants of poverty, education attendance, demographic trends and health services, and the relationship between employment and poverty. Moreover, INE is expected to finalize a labor force survey by September 2005 that will provide information on unemployment using a variety of definitions. A new PARPA covering the period 2006-10 will be prepared during 2005 and is expected to be ready by February 2006.

V. PROGRAM MONITORING

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

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

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

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

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

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

MOZAMBIQUE

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

Maputo, January 24, 2005

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

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

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

Government's domestic primary balance

2. The government's domestic primary balance is defined as government revenue, **less** noninterest current expenditure, **less** locally financed capital expenditure, **less** locally financed net lending. It excludes bank restructuring costs, the cost of recapitalizing the central bank, project expenditure, and capital expenditure financed with proceeds from the coal mining concession. Net lending is derived as gross lending to enterprises through *acordos de retrocessão* (excluding *acordos de retrocessão* that were required by donors), **plus** food aid disbursed but not collected in the period, **minus** repayments by enterprises of loans obtained through *acordos de retrocessão* and through refinancing agreements with the Bank of Mozambique, **minus** food aid collected but not disbursed in the period. Unallocated revenue or expenditure arising from discrepancies between the government balance measured from above the line and the balance measured from below the line will be part of the government's domestic primary balance.

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

Government revenue, expenditure, and financing

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

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

6. **Expenditure** is defined as government outlays transferred from treasury accounts to other government accounts or private sector accounts, and includes spending reported to the National Directorate of Public Accounting (*despesas liquidadas*) and any further treasury advances (*operações de Tesouraria*) that have been transferred out of treasury accounts but whose use has not yet been reported to the National Directorate of Public Accounting. It also includes expenditure financed with the own-generated revenue of districts and some line ministries referred to above.

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

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

Net domestic assets

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

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

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

Net international reserves

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

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

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

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

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

Stock of short-term external public debt outstanding

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

External payments arrears

17. The government undertakes not to incur payments arrears on external debt owed or guaranteed by the government, with the exception of external payments arrears arising from

government debt that is being renegotiated with creditors, including Paris Club creditors. This performance criterion will be assessed on a continuous basis.

Foreign program assistance

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

Actual external debt-service payments

19. Actual external debt-service payments are defined as cash payments on external debt-service obligations of the government and central bank, including obligations to Paris Club and other bilateral creditors rescheduled under enhanced HIPC Initiative completion point terms, multilateral creditors, and private creditors (Table 1).

Adjusters

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

21. The quantitative targets (ceilings) for the central bank's net domestic assets will be adjusted upward (downward) for any shortfall (excess) in disbursement of external program grants and loans, compared to the program baseline; and downward (upward) to the extent that actual payments of external debt service fall short of (exceed) programmed amounts (Table 1). They will also be adjusted downward for the full amount of any privatization proceeds in excess of those envisaged in the program, unless these proceeds are deposited in the government's savings account abroad. If they are deposited abroad, the indicative targets on the balance in this account will be adjusted upward for the full amount of the higher than envisaged proceeds, net of any costs related to the privatizations, including severance payments.

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

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

Data reporting

24. In addition to providing the monthly and quarterly data needed to monitor program implementation in relation to the programs' quantitative targets and broader economic developments, the authorities will provide weekly updates of the daily data set out in Table 3 of this attachment, as well as the weekly data set out in Table 4. Monthly updates will also be provided of the foreign exchange cash flow of the Bank of Mozambique, as set out in Table 5.

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

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

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

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

- (a) Daily monitoring of BIM's liquidity position.
- (b) Monitoring of monthly cash flow statements and reports on profitability, accompanied by relevant comments.
- (c) Monitoring of monthly results of operational restructuring, including reductions in staff and branches, and of progress achieved by the bank's special unit in charge of collecting nonperforming loans.
- (d) Prohibition of any distribution of dividends by BIM.

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

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

(In millions of US dollars)

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

Source: Mozambican authorities; and Fund staff estimates.

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

(In millions of US dollars)

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

Source: Mozambican authorities; and Fund staff estimates.

Table 3. Mozambique: Daily Foreign Exchange Rates and Foreign Exchange Transactions, Week of
[month/day-month/day]

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

Source: Bank of Mozambique.