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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 98/41

2:30 p.m., April 7, 1998

Contents

Executive Board Attendance

A.D. Ouattara, Acting Chairman

Executive Directors	Alternate Executive Directors
	A.S. Alosaimi, Temporary
	T. Turner-Huggins, Temporary
	R.J. Singh, Temporary
	W.-D. Donecker
	J.N. Santos, Temporary
D.Z. Guti	J.P. de Morais
	O.-P. Lehmussaari
	H. Mori, Temporary
	N. Goffinet, Temporary
K. Lissakers	
	R. Fernandez
	S. Rouai, Temporary
	A. Vernikov
	J. Shields
	M.H. Elhage, Temporary
	N. Jadhav, Temporary
	J.K. Honeyfield, Temporary
	J.L. Pascual, Temporary
	L.B.J. van Geest, Temporary
	D. Saha, Temporary
	D. Fujii, Temporary
	Phan M.H., Temporary
	Zhang F., Temporary
	O.A. Hendrick, Temporary

A. Mountford, Acting Secretary
S.W. Tenney, Assistant

Republic of Mozambique—1998 Article IV Consultation; Enhanced Structural Adjustment Facility—Review Under Second Annual Arrangement; and Initiative for Heavily Indebted Poor Countries—Final Assessment of Eligibility

Staff representatives: Leite, AFR; Boote, PDR; Pomerantz, IBRD

Also Present

African Development Bank: A. Mwaba. IBRD: R.P. Castro, P.R. Pomerantz, and M.T. Stephens, Africa Regional Office. African Department: E.A. Calamitsis, Director; A. Basu, Deputy Director; S. Fabrizio, E.C. Harris, S.P. Leite, P. Ramlogan, F.C. Ribe, K. Udovicki. Legal Department: R.C. Baban. Middle Eastern Department: M.M. Lazare. Policy Development and Review Department: J.T. Boorman, Director; T. Leddy, Deputy Director; A.R. Boote, H.W. Bredenkamp, M. Castello-Branco, C. Daseking, A.T. MacArthur, D.C. Ross. Secretary's Department: B.A. Sarr. Advisors to Executive Directors: E. Jourcin, H. Ogushi, Y. Patel. Assistants to Executive Directors: K.S. Brownlee, K. Kask, F. Mercusa, T. Presečan, T.T. Schneider.

1. REPUBLIC OF MOZAMBIQUE— 1998 ARTICLE IV CONSULTATION; ENHANCED STRUCTURAL ADJUSTMENT FACILITY— REVIEW UNDER SECOND ANNUAL ARRANGEMENT; AND INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES— FINAL ASSESSMENT OF ELIGIBILITY

The Executive Directors considered the staff report for the 1998 Article IV consultation with the Republic of Mozambique and midterm review under the second annual arrangement under the Enhanced Structural Adjustment Facility (ESAF) (EBS/98/57, 3/24/98; Cor. 1, 3/31/98), together with a final paper, prepared jointly by the staffs of the Fund and the International Development Association, presenting a final assessment of the Republic of Mozambique's eligibility for assistance under the Initiative for Heavily Indebted Poor Countries (HIPC) (EBS/98/66, 3/31/98; Sup. 1, 4/6/98). They also had before them a staff paper on selected issues (SM/98/78, 3/26/98; Cor. 1, 4/1/98).

The staff representative from the African Department made the following statement:

> Late last week, the Russian authorities agreed to increase exceptional net present value relief on post-cutoff-date arrears from the assumed 50 percent to 56 percent, instead of expanding the coverage to all post-cutoff-date debt, as had been assumed in paragraph 44 of the final HIPC document. The resulting overall net present value of debt to Russia is still the same as shown in the final HIPC document. Also, the external debt and balance of payments data in the final HIPC document differ marginally from those in the staff report because the staff report was issued at a time when burdensharing issues had not yet been completely resolved.
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> Prices and exchange rates remained relatively stable in the first quarter of 1998. Accumulated inflation in the first quarter of the year, which is traditionally the quarter with the sharpest price increase, is estimated at 3.9 percent compared with 6.9 percent for the same period last year. The metical depreciated by only 0.7 percent in the first quarter.
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> The local government elections, which the HIPC document mentions as being held in May this year, were postponed to June 30 to permit the electoral commission to address some opposition party concerns about voter registration.
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> Finally, the Executive Board of IDA early today approved the decision on the HIPC Initiative for Mozambique, consistent with all the recommendations in paragraphs 53 to 57 of the joint final HIPC document.

Mrs. Guti made the following statement:

The past 11 years of economic reform in Mozambique, supported by successive SAF and ESAF arrangements, have produced notable strides towards macroeconomic stability and economic liberalization. Undoubtedly, the signing of the Peace Accords in 1992 has played an invaluable role in creating a more propitious environment for change, and economic performance in recent years has been marked by high rates of growth, averaging 6.7 percent per annum, and declining inflation, which has plummeted since then, reaching a single-digit figure in 1997. Domestic and external financial imbalances have also been reduced. Complementing these efforts is the substantial progress that has been made on structural reforms, in particular in the financial, trade, exchange, and legal areas, contributing to increased economic efficiency and improved management. Renewed confidence has also led both the domestic and foreign private sectors to play an increasingly predominant role in the economy.

These achievements notwithstanding, the authorities continue to face trying difficulties, all of which can be summed up in the challenge of widespread poverty. The statistics are grim: per capita income at US$90 is one of the lowest in the world, and two-thirds of the population are below the poverty line. In these circumstances the heavy debt burden of the country is not just an issue of external viability but also of the constraint on the government to finance poverty reduction programs and the reconstruction of basic infrastructures and those necessary for the development of the private sector.

The strategy of pursuing high growth rates with price stability has been and remains the authorities' first line of defense for raising living standards in Mozambique. As Directors are aware, this is the driving force of the program financed under the ESAF. To that effect, the authorities are totally committed to persevering with prudent macroeconomic policies and maintaining further deepening of structural reforms. The objective is for the economy to continue to grow at a rate of 6–8 percent with inflation below 8 percent. However, it cannot be overemphasized that debt relief is a major element in the matrix for strengthening the basis for sustained growth and poverty alleviation, in the context of the HIPC Initiative.

Performance under the 1997/98 program was on track, with macroeconomic targets being exceeded in many cases by substantial margins. It is to be noted, in this regard, that during 1997, real GDP growth at about 8 percent was much higher than the program target, and inflation plummeted for the first time to a single-digit figure of 5.8 percent, against 14 percent estimated under the program, owing largely to a strong supply response of the economy. Also, the overall fiscal deficit, before grants, was below the target by 1.4 percentage points relative to GDP, making it possible for a higher level of government repayments to the banking system than anticipated under the program. Reflecting improvements in the trade balance, the external current account position was further strengthened, resulting in a significant decline in the deficit of 7.3 percentage points of GDP, compared with 1996. It is also 5.2 percent below the program target. As a result, gross international reserves increased to the equivalent of 6.4 months of imports. Consequently, all quantitative and structural performance criteria and benchmarks for the first half of the year (end-September 1997) were observed with the exception of (i) the net foreign assets (NFA), due to a lag in export receipts, and (ii) the net domestic assets (NDA), which, after consultation with the Fund staff, was allowed to exceed the target in order to accommodate the higher-than-expected money demand induced by the more vibrant economic activity.

The improvement in the fiscal position reflected increased tax collection as a result of improved tax administration, including a substantial reduction in exemptions and expenditure restraint. Particular attention will continue to be accorded to improving revenue performance. To that effect, efforts are being directed to further improving the efficiency of the internal and customs tax administration, and to lay the ground for a smooth introduction of the value-added tax (VAT). In order to ensure revenue neutrality, the authorities are considering the introduction of additional tax measures to compensate for any potential revenue losses as a result of the move towards the introduction of the VAT and the proposed reforms of the direct tax structure.

Expenditures will remain under tight control, and efforts will continue to be made to improve the management of the public sector. In this respect, a medium-term Expenditure Management Reform Strategy was initiated in 1997 calling for a new budget law and the development of a medium-term expenditure program to match policy priorities and resource availability. As part of the fight against the widespread poverty, the share of the public resources budgeted to the social sectors, which now account for over 14 percent of total expenditures, has been augmented, with the largest allocation going to health and education. In order to keep the pension scheme financially sound, the authorities are considering various options to relieve pressure stemming from the sharp rise in the number of pensioners as a result of the 1992 Peace Accord, including providing a cash incentive for those wanting to leave the scheme voluntarily and the possibility of developing a private pension system.

Efforts made by the authorities so far towards fiscal consolidation have resulted in surpluses on the current balance since 1995. While there could be room for improvement on the productivity of investment, my authorities believe that, given the vast requirements to rebuild the economy, largely necessitated by the need to reconstruct basic infrastructures severely damaged by the war and to address the needs of the deprived social sectors, it is critical that investments be allowed to grow at a faster pace. Obviously, and as envisaged under the new budget law, the sustainability of the investment programs would be taken into account when formulating expenditure programs.

Notwithstanding the significant improvements made so far, monetary policy will continue to be geared to contain inflation. Credit policy, while accommodating the requirements of a fast-growing economy, will be kept under close monitoring to avoid the resurgence of inflationary pressures. Reflecting a redirectioning of the allocation of resources away from financing the public sector, domestic credit to the private sector expanded by 21 percent in 1997. In its move towards using indirect instruments of monetary control, the central bank has implemented a series of measures, including the modernization of the payments system and the establishment of an interbank money market, to be complemented by the creation of a stock exchange next May. Meanwhile, to ensure the soundness of the banking system, the central bank supervisory functions will be further strengthened and the prudential regulations already in place, strictly enforced.

The authorities are determined to continue to build on the significant progress already made in structural reforms. Recognizing that the agenda is far from over, they will continue to deepen the ongoing reforms in the financial, trade, and privatization sectors as envisaged in the program, while adjusting and improving the legal and regulatory framework, in line with the new economic realities, so that the economic environment is made more attractive to private-sector investors.

Mozambique's external position remains highly vulnerable. In spite of the meaningful progress made under the various adjustment programs towards macroeconomic stability and structural reforms, external viability remains elusive. The level of the country's external debt is visibly unsustainable, as clearly reflected by the different debt indicators in the current updated debt-sustainability analysis. The heavy burden on both the budget and the balance of payments is a restrictive element on the authorities' ability to meet the demands of poverty reduction and reconstruction needs, and hampers their efforts in support of the ongoing process of economic development in a more determinant determinate manner. At the time of the discussion of the preliminary HIPC paper last September, recognizing the unsustainability of the situation and given the country's good track record of economic performance, there was consensus about Mozambique's eligibility under the HIPC Initiative. Given the high fragility of the fiscal and external positions and considering the vast dimension of the economic and social problems still to be resolved, there was also broad agreement that the NPV of debt-to-exports target of 200 percent and a debt-service ratio below 20 percent at the completion point would be appropriate.

For my authorities to be able to reap effectively the benefits of this initiative, it is important that the relief be provided at the highest level possible, in order to reduce the debt burden to a realistically manageable level. This is even more important given the uncertainties of some export projections that may not materialize in the near future as projected. The initiative foresees the possibility of a shortening of the second phase for countries that have established a record of strong performance. My Mozambican authorities have demonstrated, over the past 11 years, their strong commitment to adjustment and reform, translated in the good track record of economic performance. They believe, therefore, that an agreement on a completion point in December 1998, as requested previously, will only do justice to the efforts they have made in implementing economic reforms under very difficult conditions. Moreover, deferring further the completion point will be mainly penalizing the country for factors that were out of its control which have led to a delay of almost a year to consider its case, barring which Mozambique would have been among the first cases considered in the earlier part of last year.

In conclusion, my authorities would like to extend their appreciation to the staff for the excellent set of papers produced for this meeting and for the continuous support that the international community, including the Bretton Woods institutions, has been providing to Mozambique.

Mr. Mori made the following statement.

Mozambique has achieved impressive progress in the period 1987–97. Since 1987, the authorities have been implementing a wide-ranging program of economic stabilization and structural reform, involving a shift towards market-oriented policies and a sharp reduction in the size of the public sector. Real GDP and exports grew on average by 6.8 percent and 15.6 percent, respectively. The rate of inflation, which consistently averaged 47 percent from 1987 to 1995, fell dramatically from 70.1 percent to 16.6 percent, as the authorities markedly tightened monetary policy.

In 1997, real GDP growth is estimated at 7.9 percent, with vigorous growth in all major sectors; inflation continued its steady decline, reaching 5.8 percent, the lowest since Mozambique's independence in 1975. Fiscal policy is tighter than programmed. The external current account deficit is estimated at 13.4 percent of GDP, a decline of nine percentage points of GDP since 1995. However, the external debt burden remains heavy, at 283 percent of GDP with present value at 685 percent of exports of goods and nonfactor services.

In the medium term, exports and the private sector will play a fundamental role in the objective of maintaining a high and sustainable GDP growth rate. The enhancement of export competitiveness, removal of supply bottlenecks, and creation of a business-friendly environment are important ingredients for this objective. Growth-oriented policies should necessarily be complemented by programs of assistance to the poor. We encourage the authorities to continue to follow policies to ensure that the public sector and external deficits are sustainable and that underlying expenditures are consistent with the country's absorptive capacity. Furthermore, the authorities need to take prompt action if there are indications that excess demand is building up.

Given the heavy external debt burden and concerns about the sustainability of expenditures, we agree that the best policy to achieve higher investment is through an increase in domestic savings. Key initiatives to raise domestic savings would be improvements in the tax and pension systems, restraint on current expenditure, and steps to increase financial deepening. It is also important to pay more attention to improving the productivity of investment by enhancing the quality of the investment program, and to the recurrent cost implications of higher investment spending.

Mozambique's performance under the program has been satisfactory. Four of the six end-September 1997 quantitative benchmarks were observed. All the end-December 1997 quantitative benchmarks were observed, except that relating to the NDA of the banking system. All the structural performance criteria and benchmarks of the 1997/98 program have been, or are being, observed. It is noteworthy that 32 large enterprises were privatized in 1997 as against 16 required in the program, and the last remaining state-owned commercial bank was privatized. We commend the authorities for the ongoing efforts to strengthen tax administration which are beginning to pay off, as reflected in the good revenue performance in 1997. We encourage the authorities to move expeditiously on the remaining structural reforms.

The nonobservance of the NDA of the banking system is understandable. In a context of changing circumstances, estimating money demand is difficult. The attainment of the inflation objective by a significant margin, despite the overshooting of the monetary target, may support the hypothesis that money demand was stronger than anticipated. A more flexible money stance avoided the negative effect on growth that might have resulted had the original NDA targets been maintained. For the NFA shortfall through end-September, this was related to a delay in export receipts expected in the third quarter of 1997 and was corrected in the fourth quarter, as by end-December 1997 the NFA had exceeded the programmed amount.

The authorities need to persevere in following prudent policies to attain all quantitative and structural benchmarks through March 1998. At this stage, we agree not to revise the program for the first quarter of 1998, especially for the NDA of the banking system in view of the uncertainties regarding money demand.

We support the proposed decisions on the Second Annual Arrangement under the ESAF and 1998 Article XIV Consultation, as well as the decision on Mozambique's eligibility for the HIPC Initiative. We agree with the recommendation that the decision point will take place in April 1998. With regard to the completion point, we consider June 1999 as appropriate, but we may also consider shortening the second stage to take place in end-1998, provided Mozambique maintains a solid performance record and implements the necessary policies. We support the staff and management suggestion of the target for Mozambique's NPV of debt-to-exports ratio of 200 percent. Access to enhanced debt relief under the initiative will be conditional upon satisfactory implementation of a strong program of structural reform, with special attention to social issues.

Mr. Shields made the following statement:

I would like to take this opportunity to thank management and the staff for their efforts in bringing these clear and well-presented documents to the Board. I think the section on medium-term issues for the Article IV paper provided a particularly useful analysis on key topics.

When we looked at the preliminary HIPC document last September, we considered at length Mozambique's eligibility and questions concerning its strong track record and vulnerability. I would like to review our conclusions based on the issues for discussion on page 29 of the staff report.

Firstly, we feel that Mozambique is eligible for assistance. Today is the correct decision point, and we are content for Mozambique to look to a completion point of mid-1999, subject to maintenance of performance under a third annual ESAF arrangement.

Secondly, given the vulnerability to exogenous shocks, we think the targets for debt sustainability should be set at 200 percent for the net present value of debt-to-exports ratio, and at 20 percent for the debt-service ratio.

Finally, I strongly support management's proposal to supplement bilateral resources with an additional contribution in order to fill the financing gap.

I think it is also right to offer our thanks to all those concerned with resolving the large financing problems. The process has certainly been long and occasionally difficult. But through a concerted effort by all involved, we have arrived at a sensible and robust solution. I think there have been particularly exceptional efforts on the Russian side. I would also like to thank other creditors for their contribution to the financing gap, and the Paris Club secretariat for their unstinting efforts. I think this is particularly important in the case of Mozambique, an exceptionally poor country which faces great difficulties and a heavy debt burden but which now has a history of strenuous efforts at reform and some very good prospects for the years to come.

On the reform program itself, I think this is a crucial stage in the development agenda. Recently, there has been a strong and in some cases exceptional performance—exhibited by improvements in Mozambique's macroeconomic position in 1997. Above-target growth was achieved at 8 percent, with inflation at around 5 percent. The currency has been stable. Foreign investment is both welcomed into Mozambique and is actually arriving. But, as the staff notes in its report, the situation does remain fragile, and a full reform agenda remains. I would just like to comment on a few specific areas: trade liberalization, revenue, and the civil service.

There was certainly commendable effort on trade liberalization in 1996, but this is one area where more recent progress and intentions have been disappointing. I would urge the authorities to renew their efforts to reduce tariff barriers and import tax exemptions. While a reduction in overall external tariff barriers would be preferable, Mozambique's membership in the South African Development Community is at least a partial first step in the right direction. Still, I was surprised that the government had sought an extension on the eight-year time frame for the elimination of tariffs on intra-regional trade. If we are looking for momentum and trying to give life to a process of liberalization, a 15-year time frame seems excessive. I think the government could be much less cautious in this area. In particular, as the Selected Issues paper notes, Mozambique has a considerable wage advantage over South Africa and other member states, so I think that it can afford to be more ambitious.

Turning to the question of revenue, there have been some very good recent efforts to strengthen revenue performance, and the tax reform agenda for the current year is formidable. A key element is the introduction of a value-added tax, which is a crucial step in broadening the tax base. It is important, though, that there is sufficient groundwork to ensure successful implementation, including the establishment of sufficient administrative capacity and completion of a public awareness campaign. I fear that because of these technical factors, the start date of July this year may be somewhat ambitious. There are comments on this issue in the staff paper. I would be grateful if the staff could give its latest views on the likely timetable for the value-added tax and any implications for the overall program.

The public sector in Mozambique is not large relative to other countries in Africa, but there is still considerable room for reform in terms of salary scale revision and reorganization of management. The drift of skilled and valuable staff to the private sector needs to be reduced. Although the authorities have set an implementation date of April 1999, this may be one area where, in fact, there could have been faster progress. It is clearly true that this type of reform is difficult politically, but there is no large-scale retrenchment plan—which is normally the thing that slows down these reforms.

I would also like to comment on the staff report's discussion on the fiscal deficit before grants, contained in section IV.B. This is a useful section, and it is right to point out that the Fund is not as inflexible as sometimes portrayed when taking into account the flow of donor funds. However, it is also correct that more coordination is needed in terms of establishing what the likely flow of funds will be and making sure that donors have all the right arrangements in place. Hopefully, if we can improve our coordination in this area, we should be able to present and agree on targets for fiscal deficits before grants which more completely take into account the investment and growth benefits of these grants.

Finally, I support the granting of waivers on net domestic assets and net foreign assets. The staff seems to be right that much of the overshooting of these targets was due to remonetization following the period of stabilization, and it seems as if the overall monetary stance was appropriate. The fact that this was understood and taken on board suggests a maturity in the handling of policy and also in the handling of relations between the staff and the authorities. This maturity bodes well for the future maintenance of these relations and a successful outcome for Mozambique.

Mr. Singh made the following statement:

I would first like to join Mr. Shields in thanking the staff, both of the Bank and of the Fund, for providing us with an update on the situation of Mozambique under the HIPC Initiative. We appreciate the special efforts in completing the documents for this Board meeting in the face of ever-changing numbers.

Mozambique's recent economic performance is impressive. The growth rate of the economy accelerated in 1997 beyond expectations, and the inflation rate was further reduced, at a level below the program target. The external position strengthened, allowing a buildup in reserves and a stable exchange rate.

However, this success created some problems. The faster decline in inflation triggered a greater-than-expected increase in the demand for money.

Accommodating this return of confidence in the local currency put the monetary targets for end-September out of reach. As this overshooting is the reflection of a rather positive outcome, the authorities' decision should not be penalized. We agree therefore to grant the needed waivers and complete the midterm review.

The encouraging economic results confirm Mozambique's long-standing and strong adjustment record. Despite these positive developments, however, the country will continue to face an unsustainable debt level. Mozambique is therefore clearly eligible for relief under the HIPC Initiative, and we support a decision point as of today. We could also support a completion point in mid-1999. In agreeing to shorten the interim period, we express our confidence that the authorities of Mozambique will be able to fully implement the economic program by that date.

The high variability of Mozambique's export earnings and the heavy fiscal burden of its public external debt indicate that the country is more vulnerable than the average of the control group. We therefore agree to set the target levels for debt sustainability at 200 percent for the NPV of debt-to-exports ratio and to 20 percent for the debt-service ratio.

We acknowledge the great efforts the staff of the Bank and of the Fund have put into the negotiations with the bilateral creditors in order to finance the residual bilateral gap. We welcome the additional relief provided by certain members of the Paris Club. Although we would have preferred a fully proportional burden-sharing, we can endorse in the case of Mozambique on an exceptional basis the proposal that the Bank and the Fund provide an additional contribution to what would be required under a proportional burden-sharing. A question remains nevertheless regarding the participation of the other multilateral institutions, especially the African Development Bank. We would welcome any further details the staff may have on this issue.

Turning now to the policy framework, we agree with the proposed measures and would like here simply to emphasize some points. Public-sector and fiscal reforms, such as those regarding the civil service, the customs, and taxes, are of particular importance and need to be accelerated. The VAT should be introduced as early as possible and further efforts to improve the tax structure be made. The tax structure should be simpler, both from a taxpayer's as well as from an administrative point of view, have a broader base, and be less discriminating against the formal sector.

On the expenditure side, we welcome the efforts to begin the implementation of the Expenditure Management Reform Strategy, as these measures should improve the transparency and the efficiency of the government's activities. This latter aspect is of particular importance, since the investment ratio in Mozambique is relatively high, and concerns about the absorption and the implementation capacity of the country exist. In this respect, greater donor coordination and more predictable aid flows would also help.

On the issue of pensions, the idea to offer a cash incentive for demobilized soldiers to voluntarily leave the system is worth investigating further, and we encourage the authorities to explore the readiness of the donor community to finance such an option. As Parliament has passed a law requiring mandatory military service, some close monitoring of military expenditure could be warranted, as well as greater transparency in military budgeting and spending.

Finally, the case of Mozambique illustrates again the uncertainties surrounding the implementation of the HIPC Initiative, such as the outcome of the debt data reconciliation exercise and the quality of the balance of payments projections used for the baseline scenarios. We are particularly concerned here about the considerable changes in projections for the balance of payments between the preliminary and the final documents. The difference is especially high for the current account deficit, where a dramatic increase can be observed for the years 1999 and 2000. We would appreciate it if the staff could explain why there is such a strong deviation from the projections prepared only six months ago.

Mr. Saha made the following statement:

Like previous speakers, I would like to commend the staff for their concise and well-focused set of papers. I share most of their policy recommendations and shall limit my comments to a few issues.

The Mozambican authorities deserve to be commended for continuing to strengthen their macroeconomic performance in recent years. Economic activity recorded a high rate of growth, and inflation was brought to a single digit in 1997. Domestic and external imbalances have also been reduced, and progress has been achieved in the structural area. On the basis of these impressive achievements and the reasons given by Mrs. Guti in her very useful statements, this chair supports the authorities' request for waivers.

At this juncture, I would like to encourage the authorities to pursue their determined commitment to sound financial policies and far-reaching structural reforms. This needs to be supported by the continued strengthening of the country's administrative and institutional capacity.

In the fiscal sector, the progress made in revenue collection and expenditure restraint is welcome. This has brought about a significant improvement in the budgetary position. More needs, however, to be done in order to reduce the overall fiscal deficit to a sustainable level.

In this regard, the internal tax services should be strengthened further. The reform of the customs administration is bearing fruit, but its performance should be consolidated. In that context, it is important that the donor community provide the necessary financing for staff training and redeployment.

On the revenue side, a smooth and successful introduction of the VAT is needed. To this end, the authorities should step up their preparation efforts, drawing on the ongoing FAD technical assistance. Moreover, the policy of granting exemptions needs to be reviewed urgently, with a view to shortening the proposed list of exemptions. Here, I wonder whether the staff could comment on the rationale for granting exemptions to the financial institutions. In addition, the authorities should minimize the level of a forgone revenue that could be expected from the reform of direct taxation.

On the expenditure side, efforts to reorient expenditure towards high-priority sectors represent steps in the right direction. Particularly noteworthy is a significant reduction in GDP terms of the military and salary outlays. Nevertheless, the authorities are encouraged to pursue a prudent wage policy while accelerating the civil service reform during the years ahead.

Concerns on the pension systems are justified. Therefore, I encourage the authorities to address them urgently. I also share the staff concern on the public investment program, and I am of the view that the authorities should review carefully its efficiency and its recurrent cost implications on the budget. Also, the sustainability of the aid-financed expenditures needs to be reviewed carefully, in collaboration with donors.

In the monetary sector, the authorities should maintain a tight policy stance in order to contain demand pressures on available resources. In this regard, I welcome the efforts being made to introduce indirect instruments of monetary policy and strengthen the banking supervision and the prudential regulations. As regards the structural rigidities that have contributed to high cost of financial intermediation, efforts are needed to improve the judiciary system and the accounting and business management practices.

On structural reforms, the authorities deserve our commendation for progress made on several fronts, particularly in the privatization of the public enterprises and the commercial banks. I encourage them to increase their efforts in the restructuring of the remaining public enterprises, the reform of civil service, and trade liberalization.

Turning now to the HIPC Initiative, as clearly indicated in the staff paper, Mozambique's external debt burden is unsustainable, despite the debt reliefs granted by the donor community. In this connection, because of its strong record of adjustment under Fund-supported programs since 1987 and the pressing issue of poverty alleviation, Mozambique deserves additional debt relief under the HIPC Initiative. In that context, I would support a decision point this April, and the completion point in December 1998, with the understanding that the authorities will pursue vigorously the reform efforts under the ESAF arrangement. Given the economy's vulnerability to external shocks, I can support the staff proposal for a target of 200 percent for the ratio of the NPV of debt to exports, and a target of 20 percent for the debt-service ratio. I also commend the Fund and the World Bank for their voluntary contribution to close the residual financing gap, up to one-third.

Finally, let me commend the Fund management and the staff for providing comprehensive technical assistance to Mozambique over the past years. This assistance has been very useful in transforming the economy into an increasingly market-oriented system. It is therefore my expectation that this assistance will continue on the key policy areas, as well as to improve the statistical data that is critical for policy monitoring and development.

With these remarks, I support the proposed decisions and wish the Mozambican authorities continued success in the reform of their economy.

Mr. Vernikov made the following statement:

First of all, allow me to congratulate Mr. Leite and his team for the work done on Mozambique. It is a very complicated case in view of the diverse challenges facing this country. I liked the format and the form of presentation of the material in the staff paper, namely the staff-formulated questions addressing crucial policy issues, allowing us to focus our attention in a helpful way.

Article IV Consultation and Review Under the ESAF

I join previous speakers in commending the authorities for their macroeconomic achievements with regard to low inflation, high growth rates, and exchange rate stability, as well as the structural reform area, although I feel that those might be speeded up. The reasons for the requested waivers for nonobservance of two performance criteria—NDA and NFA—are understandably related mainly to the circumstances in which monetary policy was carried out, so I can support these waivers. Since I agree with most of the staff analysis, I would like to comment on only two issues—the fiscal deficit and the external position.

Fiscal deficit. The staff paper raises the question of whether Mozambique's fiscal deficit should be seen as too large or too small. To my mind, at its current level of an average of 22 percent of GDP in 1993–97, the fiscal deficit is, in the longer run, clearly unsustainable and unviable. Staff indicated that fiscal policy is tighter than programmed. Maybe this is indeed the case. But the overall deficit before grants is projected to improve very insignificantly—to 19.4 percent in 1998 from 20.1 percent in 1997. Furthermore, in 1998, the domestic primary balance (at 16.4 percent) is not set to improve, and the overall balance after grants will even deteriorate—from –5.7 percent in 1997 to –6.2 percent in 1998. It seems that fiscal consolidation should be implemented more aggressively. Despite the fact that Mozambique is a very poor country and revenue sources are limited, something can and should be done. Like Mr. Shields, I look forward to seeing the VAT being phased in. In any event, there is no alternative to living within the means. If there is no internal balance in the economy, it will inevitably generate new external imbalances, and the external debt burden may start building up again.

Reliance on foreign aid remains very high in Mozambique. I cannot agree more with the staff's view that the authorities need to consider the issue of the sustainability of aid-financed expenditures and to ensure that aid is used to maximize the country's development potential. To this end, the focus must shift from the level of investment to its allocation and efficiency. The authorities will have to gradually overcome the culture of having foreign aid–financed budgets. Some circumstances play in their favor—thus, interest payments on public debt tend to decrease in an environment of low inflation. However, I noted that wages and salaries are set to increase again as a proportion of GDP. I also agree with the staff that the best way to achieve higher investment is through an increase in domestic savings.

External position. It is commendable that international reserves stay at a comfortable level. As far as exports are concerned, their amount has still been below the 1980 level, despite impressive growth in recent years. I believe that there remains substantial export potential to be tapped. I would invite the authorities to look actively for ways to enhance exports of goods and services, perhaps through further trade liberalization.

A small additional point is that I am not sure how meaningful it is, given the circumstances of Mozambique, to portray balance of payments projections until the year 2015 (EBS/98/57, page 42). There are too many uncertainties for those estimates to be acceptably accurate.

HIPC

I agree that Mozambique is eligible and should qualify for assistance under the HIPC Initiative. We can go along with the proposed external debt sustainability target of 200 percent of debt-to-exports and 20 percent of debt-service-to-exports at the completion point. Completion point in June 1999 would seem appropriate, in view of Mozambique's exceptional circumstances.

The word "exceptional" is crucial in assessing the action taken by bilateral official creditors and to be taken yet by multilaterals. I would like to confirm what Mr. Leite said at the beginning of this meeting with respect to the contribution committed by the Russian Federation. Indeed, under my authorities' new proposal and in accordance with the Memorandum of Understanding with the Paris Club of creditors of September 1997, the amount of Russia's reconciled post–cutoff date arrears, after application of the previously agreed 80 percent upfront discount, would be further treated so as to reduce it by an additional 56 percent in NPV terms. At the same time, my authorities believe that this proposal has been developed as an ad hoc solution to Mozambique's problem and should not be seen as a precedent for future cases. Under the conditions of exceptionality, I can endorse the proposed action to be taken by the IMF at the completion point.

Having said that, I would note that we remain concerned about the fact that the credibility of the Guidelines for the implementation of HIPC Initiative gets eroded further with each "exceptional" case when, for instance, the length of the period between decision and completion points is shortened. Strictly speaking, the Guidelines have not yet been applied in their original form. However, this issue is not directly related to the decisions we need to make today.

There is something on page 21 of the HIPC document that caught my eye. The staff mentions that "Mozambique should not be penalized if delays were incurred in reaching a decision point pending agreement on the treatment of Russian claims in the context of its participation as a creditor in the Paris Club." May I note that for many years, due to various reasons, there had been little substantive work done to reconcile bilateral claims and thus prepare the ground for a speedy conclusion of an agreement. Such work was completed recently with the debtor's full cooperation. Still, my authorities faced the need to compress the whole process in a matter of weeks, and they did whatever was feasible. Nevertheless, I would urge the authorities of other potential HIPC countries to move ahead with bilateral negotiations well ahead of our meetings on the decision point. There should be no impression that a close deadline for the Board meeting might push the creditor to go even further. If I may reformulate the staff's sentence, creditors should not be penalized by a lack of progress in bilateral talks ahead of the application of the HIPC Initiative, due to factors and policies within the debtors' control.

I would like to conclude by wishing the Mozambican authorities the best success in implementing their program and dealing with the challenges faced by their economy and society.

Mr. Santos made the following statement:

First, I would like to join previous speakers in thanking the staff for its good work. Mozambique is beginning to reap the benefits of a long record of structural reforms, with dividends now showing in a clear trend of strong and broad-based economic growth with low inflation.

Confidence is high, and future prospects appear bright. However, the economy is still at an early stage of development and remains vulnerable—its dependence on exogenous factors is exacerbated by sizeable domestic and external macroeconomic imbalances. In this context, addressing the economy's many structural weaknesses and external vulnerability should be the main goal of the authorities' policy efforts in the years ahead.

Performance under the program has been mostly positive, with further progress being made toward stabilization and structural reforms. Still, quantitative performance criteria have been breached again, and the need for change in key areas remains. Having said that, we would like to make three specific comments on the program for 1998.

First, if the monetary loosening in 1997 was appropriate, as the staff claims, then the NDA target for March 1998 should have been revised to accommodate the stronger NDA expansion in 1997. Failure to do this may unduly limit the chances that these targets are met, so that we would not have an adequate way of assessing policy performance during the first quarter of 1998.

Second, I share the staff's position that in 1998 exogenous factors should not play as important a role in reducing inflation as last year. However, while the staff projects a slight pickup in inflation, I would argue that this less-positive environment calls for an offsetting monetary tightening, consistent with an objective of nonincreasing inflation. A tightening in monetary policy would also be instrumental in maintaining a stable metical, as terms of trade gains are not expected to support the exchange rate this year. In sum, we believe it is important to preserve the positive results achieved in reducing inflation, especially in a country like Mozambique, where progress in this area has been so difficult.

Finally, while there has been an improvement in the current account deficit, the imbalance is still very large. I am concerned that the cumulative appreciation of the real effective exchange rate during the past few years, not completely matched by productivity and terms of trade gains, may place a significant damper on future export performance. Also, the positive effects of previously favorable weather conditions on both exports and imports may weaken in 1998. In light of this large external imbalance and vulnerability to exogenous factors, it is particularly important for Mozambique to proceed with supply-side reforms geared toward strengthening and diversifying domestic production and improving productivity. Progress in implementing these reforms will be vital in promoting the external viability of the Mozambican economy.

Let's focus now on the issues for discussion included in the final document of the HIPC Initiative. Mozambique clearly meets the eligibility requirements for assistance under HIPC, as it has a consolidated track record of reforms and an unsustainable external debt burden.

I agree that Mozambique has reached its decision point and is eligible to receive interim assistance under the initiative. Mid-2000 is an adequate date for the completion point, conditional on continued strong policies and progress in implementing structural reforms. We would want assurances that the core set of structural reforms is in place by this date, as these reforms are an important precondition for debt relief to be effective. Mozambique has often had difficulty implementing key reforms in areas such as customs and tax administration, including the value-added tax which has been in the pipeline for a number of years.

During the meeting on the preliminary document, we supported an NPV of debt-to-export ratio at the bottom of the proposed target range. This support was on the basis of Mozambique's external vulnerability but was conditional on creditors' reaching an acceptable agreement regarding burden-sharing of the residual financing gap. Today, as it seems agreement has been reached, we support a target of 200 percent. However, in view of the difficulties experienced in closing this gap, we feel that a target higher than 200 percent would also have been appropriate, as it would have helped to reduce the remaining gap while maintaining equity of treatment with other cases previously considered by the Board. Moreover, in the case of Mozambique, the use of a three-year average significantly underestimates export levels. As structural changes in the economy take hold and as new production is added, growing export levels will have a large impact on the NPV of debt-to-export ratio. If this ratio were to be calculated on the basis of current-year exports rather than three-year averages, the assistance level would be reduced by $190 million. It would be reduced by more than $300 million if emigrant remittances were also included. To put it differently, with the level of assistance now proposed, the NPV of debt-to-GDP ratio calculated on the basis of current-year exports would actually decline to 170 percent, or 155 if remittances are included. I mention these ranges so that we can better gauge the real effects of our decisions.

Finally, I would like to make a general comment on burden-sharing. Those who systematically favor the lowest proposed debt targets without enough regard for the availability of financing should ponder the consequences more carefully. The supply of aid resources is far from infinite. In the end, what is added on one side is inevitably subtracted from the other. There should be no illusion of aid multiplication. While we are glad to have contributed to the current agreement, we should remember that the extra efforts put forward by all parties are the exception, rather than the rule.

Mr. Fernandez made the following statement:

I will first make some brief comments on the Article IV consultation and the midterm review of the program, before turning to the issue of the HIPC Initiative.

Mozambique's macroeconomic performance in 1997 has been rather impressive. In particular, one would like to see a real GDP growth rate reaching around 8 percent more often in Africa, while inflation remains under control. This improvement was reflected by the stability of the nominal exchange rate, which is also a notable achievement for Mozambique. In fact, despite the understandable overshooting of monetary targets, linked to an unanticipated strong money demand, performance under the program was broadly on track.

Favorable exogenous factors contributed to this good macroeconomic performance, and some of them are not expected to be repeated in 1998. Nevertheless, these factors cannot be considered as the main explanation of Mozambique's performance. Significant progress was made in the implementation of the program of structural reform, especially on the fiscal front, in the financial sector and the privatization area. All these efforts are commendable and pave the way for increasing confidence and boosting private activity.

While I share the staff appraisal, I would appreciate staff's views on the sustainability of the Mozambican performance. The staff report underlines that foreign aid continues to play a significant role. Indeed, the aid-financed public expenditure remains considerable. In the private sector, the achievement of sizeable projects was the underlying factor for substantial capital flows. In the future, there may be a risk of decreased external financing with an impact on the pace of economic growth and budgetary resources. Therefore, consolidating the financial and economic situation is crucial in maintaining efforts toward reducing the budget deficit, in implementing the main structural reforms, and in undertaking the next steps in the framework of SADC free trade protocol.

Let me now turn to the HIPC Initiative.

At the outset, let me say that I totally support the staff's proposal. I agree that the decision point be set as of today, the completion point in mid-1999, and the debt target at 200 percent. The implementation of this initiative will allow Mozambique to better address its considerable social needs, and I am particularly pleased that we have been able to find a solution before the Spring Meetings: this will give a strong signal of the determination of the international community to keep the HIPC Initiative on track. Such a positive outcome would not have been possible without the joint and relentless efforts made by the Bretton Woods Institutions and the Paris Club Secretariat in order to fill the gap tied to the problem of burden-sharing. In this specific case, an innovative and tailor-made solution has been found through additional efforts by the Paris Club creditors, on a voluntary basis, and by the Bretton Woods Institutions. Comparative action from other bilateral creditors, on a strict proportional basis, will also be critical.

Finally, three additional comments. First, I can confirm the decision taken by my authorities to provide support in addition to their contributions under the Paris Club terms. Second, it must be noted that a commercial debt buyback may occur before the completion point. In this event, an evaluation of its financial impact on the Mozambican economy will be necessary. Third and finally, assistance under the initiative will amount to a very high share of Mozambique's GDP on the completion point year. It will therefore be critical to carefully monitor the absorption capacity of the economy at this time.

Mr. Hendrick made the following statement:

This chair wishes to join other Directors in commending the staff for their good work and the Mozambican authorities for their continuing strong progress in economic management. Most of the structural performance criteria and benchmarks have been met and we are very pleased with the strong performance in recent years. However, despite these remarkable achievements, as highlighted in Mrs. Guti's helpful statement, Mozambique's economy is still fragile—dependent on weather conditions and foreign aid. Grant receipts are equivalent to more than 70 percent of tax and nontax revenues, and it remains one of the poorest and most heavily indebted countries in the world.

Since we are in broad agreement with the staff appraisal, I will concentrate on the issues for discussion.

First, regarding the nonobservance of the NDA target for end-September 1997, we understand that high economic activity and high real interest rates played a role in explaining higher money demand. However, the question remains whether such a high level of economic activity is sustainable in terms of productive capacity, and to what extent the disinflation process stems from exchange rate appreciation and lower import prices. We have to be careful about the possibility of overheating the economy.

In addition, in terms of the money supply, we wonder if it may be advisable to homogenize the reserve requirement to include the time deposits of more than one year. On the other hand, the quantitative NDA benchmark for end-December 1997 was not observed. As Mr. Santos points out, since the Mozambican authorities and the staff have agreed not to revise the program, will this mean that an additional waiver will be needed at end-March 1998 for the NDA target as well? Staff comments would be appreciated.

We welcome the strong progress in privatization in 1997, particularly the completion of privatization of the last remaining state-owned commercial bank, the submission of a new financial institution law to the Assembly of the Republic, and the establishment of a stock exchange by May 1998. These actions will help to strengthen the financial system and develop domestic capital markets, improving efficiency in the financial intermediation process. We also welcome the central bank's decision to develop short-term securities markets to facilitate a shift to indirect instruments of monetary policy.

On the fiscal front, we recognize that very important steps have been taken, including the privatization of customs management, the strengthening of the internal tax department, and the implementation of the budgetary accounting framework. In any tax reform, one of the main objectives is to simplify the tax structure and make it more conducive to economic growth while not sacrificing revenue. In this regard, I wonder if the mid-98 rate reduction for the higher income bracket will be appropriate. Given that 75 percent of personal income is taxed at the current high rate of 30 percent, and considering that further tariff reduction will be coming, it may be better to wait until the ongoing improvement in internal tax administration produces an increase in revenues. We think the Mozambican authorities should be more cautious. We wonder if tax evasion considerations are a reason for this reduction. In any case, a 30 percent tax income rate is not too high considering other developing countries' experiences and Mozambique's need for improved tax revenues in the medium term.

Third, although the 1997 drop in the current account deficit by 7 percent of GDP is remarkable, this is partly explained by increased domestic output and a 32 percent real appreciation since 1995. It is also true, as the staff points out, that temporary events—such as lower import prices and official transfers 150 percent higher than usual—help in explaining this outcome. Does the staff believe that this is a structural improvement or a temporary one?

If we also take into consideration the fact that net capital inflows are believed to have declined in 1997 and are not expected to increase significantly in 1998 or over the medium term, then a further reduction in the external current account deficit will be needed. The medium- and long-term scenario presented in Table 10 of the staff report is very enlightening.

After policy measures and structural reforms are incorporated—including debt reduction under Paris Club, Naples terms, and the HIPC Initiative—a significant gap remains from 1999 all the way up to 2015, which is expected to be financed with further exceptional assistance from bilateral and multilateral creditors under the HIPC Initiative.

This chair welcomes the achievements of the Mozambican authorities in the implementation of most of the structural reforms listed in the Policy Framework Paper and encourages them to take further steps in fiscal-sector reform. The prompt introduction of a value-added tax and implementation of civil service reform is critical to reduce dependence on foreign aid, to finance expenditures, and to boost resources for meeting the rising needs of education, health, and assistance for the poor.

I would like to make a final comment on the HIPC Initiative. Given Mozambique's heavy debt burden, external vulnerability, and the impact of its excessive debt service on public finance, we support an NPV of debt-to-export target of 200 percent, and a target for the debt-service ratio of 20 percent, hoping that this will contribute to freeing up additional fiscal resources much needed to attain the objectives of their development strategy.

In addition, considering Mozambique's long track record of reform, the authorities' need of additional resources to support reconstruction and reform, and the time needed for their implementation, this chair considers that there are enough grounds for supporting a decision point at this time. We also believe that Mozambique's economy justifies approval of a completion point by mid-1999, subject to continued strong performance in the implementation of macroeconomic policies and structural reforms. This chair also supports the Fund's exceptional efforts to provide a voluntary contribution over and above what will be required under proportional burden-sharing.

With these remarks, we support the completion of the midterm review under the second annual ESAF arrangement, Article IV consultation, and the proposed decision for the HIPC Initiative. We wish the authorities every success in their challenging endeavors.

Mr. Yoshimura made the following statement:

I also thank the staff for providing concise and balanced papers. I commend the authorities for their encouraging macroeconomic performance under the second-year ESAF arrangement. This performance can be attributed mostly to decisive policy implementation, while external factors—including good weather, improved terms of trade, and an increase in offshore transfers—contributed in part. With the hope that the authorities will maintain their commitment to implement reform policies under the forthcoming third-year ESAF arrangement, I support the completion of the midterm review of the second annual ESAF arrangement.

As to the HIPC Initiative, I welcome the considerable efforts of both bilateral and multilateral creditors in filling the financial gap of $111 million, and I am pleased to note that Mozambique is now able to reach the decision point. I also impressed that the Japanese authorities are willing to provide up to 88 percent debt reduction on its eligible debt on a voluntary basis, to be consistent with fully proportional burden-sharing under the initiative.

Given these significant efforts to make Mozambique benefit from the HIPC Initiative, I agree with the staff proposals on each aspect of the initiative. At the same time I would stress that in future cases in which bilateral creditors need to provide more than 80 percent debt reduction in the present value of all their relevant debts, pragmatic resolutions should be considered on a case-by-case basis.

I would like to comment on two issues. First, it is encouraging that revenue performance has improved since 1996 through the strengthening of tax administration. The next challenge for the authorities is to establish a more stable and less distortionary tax system, focusing on the introduction of the VAT. On the expenditure side, efforts should be made to rationalize the composition of expenditures, while maintaining adequate budgetary resources for priority areas such as social-sector spending. The issue of increasing government pension payments due to demobilized soldiers should be solved quickly. In addition, the cost-effectiveness of civil service reform should be closely examined.

Second, the staff provides in the Selected Issues paper a very interesting comparative analysis among sub-Saharan African countries on the impact of investment on economic growth. According to the staff, although Mozambique had the second highest investment-to-GDP ratio in sub-Saharan Africa during 1987–95, its high investment did not result in high growth rates. In fact, Botswana and Uganda, which had much lower investment levels than Mozambique, were able to grow faster than the latter because of the higher productivity of their investments.

In order to maximize the effects of investment, it is crucial to concentrate on the most productive projects, as well as to increase the amount of investment without surpassing the absorptive capacity in the economy. I encourage the authorities to be more careful in choosing investment projects, and also in enhancing their implementation capacity. I also support the staff's suggestion that donor coordination and participation in policy framework paper discussions be facilitated. I would appreciate staff observations as to how the selection of productive and promising sectors for investment can be improved in the case of Mozambique.

With these remarks, I wish the authorities every success in their future challenges.

Mrs. van Geest made the following statement:

For the sake of brevity I will skip the compliments on Mozambique's performance and signal to points to which my authorities attach great importance—the performance of the public sector and "aid dependency."

The Public Sector

The staff appraisal states that confidence in the economy is improving steadily and that private investment is rising, and these are notable and positive developments. Nevertheless, these developments may not continue if the performance of the public service does not improve. According to some reports, private-sector investors, donor agencies, and representatives get frustrated by the inability of the public sector to deliver. Lack of qualified personnel and inability to retain qualified personnel because of insufficient remuneration levels are at the core of this problem. Public-sector reforms are therefore key for future success. In this respect, I was interested in Mr. Shields's suggestion to speed up civil service reform.

Aid Flows

The government budget shows an impressive deficit before grants. Mozambique remains highly dependent on donor funds. Policy formulation, revenue collection, and budget mechanisms need to be devised with an eye to phasing out donor contributions to the government budget. The budget policy should be geared towards a sustainable expenditure pattern. In this respect, I would echo Mr. Vernikov's statement. On the other hand, my authorities acknowledge that donors have a special responsibility to coordinate their aid efforts better.

Staff Paper

I sympathize with Mr. Santos's remark on the monetary targets. Without revision, one does not have a benchmark against which to assess performance. On the other hand, at this point in time it would seem rather late to revise the end-March target.

I would like to associate myself with the compliments paid to staff on the Q&A format of the staff paper, even if I would have liked a more quantified answer to the question of whether gross reserves are too high.

HIPC

I can support staff's proposal for a decision point at this time. I can also support a completion point by mid-1999, even if we had preferred an earlier date. Mozambique has revamped its originally centrally planned economy to a substantial degree. A completion point by mid-1999 is also in line with Mozambique's strong track record—12 years by that time.

I can support an NPV debt-to-exports target of 200, in view of the high volatility of Mozambique's exports, due to its sensitivity to climatic conditions.

It has proved difficult to arrange the assistance to Mozambique under the HIPC Initiative. As you know, my authorities attach great importance to the principle of full proportional burden-sharing. Not surprisingly, they were therefore somewhat taken aback when the discussion on this principle was reopened. We appreciate staff's efforts to bridge the resulting gap through close consultations with a wide range of countries. The Netherlands has responded in a positive manner, as is evident from the supplemental note by staff. In addition, my authorities are prepared to accept a voluntary contribution by the Fund and the Bank, over and beyond what would have been required under proportional burden-sharing. However, as far as they are concerned this can only be done on an exceptional basis, in recognition of Mozambique's strong track record and particularly challenging economic circumstances. It should not be seen as a precedent for other cases, as I explained yesterday during the discussion on Guinea-Bissau.

Ms. Lissakers made the following statement:

First, I join others in complimenting the staff for a very clear and concise and candid set of papers, which I think makes the Board's job of making an informed judgment on these programs much easier.

Secondly, I think we can all be gratified, and the staff can be for their hard work, to see Mozambique's very significant progress in improving the quality of life and living standards for their people. The strong growth performance and declining inflation, which I think is particularly noteworthy given that it has taken place in conjunction with a reduction in the current account deficit, are particularly gratifying. In light of the overall favorable performance, we are prepared to support the staff recommendations both with regard to completing the midterm review of the ESAF and to grant the requested waivers for missing the performance criteria on NDA and NFA in September and December. We agree that given the uncertainty surrounding money demand and the importance of maintaining strong growth, the government's decision to allow greater-than-projected expansion of credit is probably acceptable, although we agree with the staff that one must keep a close watch for signs of overheating.

During the discussion of Mozambique's preliminary HIPC document, I wondered whether a completion point set in mid-1999 would allow for full implementation of the myriad of reform measures Mozambique had on its agenda, including implementation of the VAT, privatizations, poverty assessments, and sectoral expenditure reviews. These were to be accompanied by tariff reforms and other structural measures. Overall I think the staff's assessment at that time that there would be sufficient time to complete these measures has been borne out. The privatization program has been exemplary, the poverty assessments have been completed, major work has been done on tax and customs administration improvements, and the first steps have been taken on the VAT.

There have been some gaps in this performance, however. Privatization of the national airline has been delayed. Preparations for the VAT have fallen behind schedule, which raises some question of whether this can be completed within the original mid-1998 time frame. Customs reform has produced strong results so far but that, too, is at risk of delay because of financing constraints. Most troubling to us is that there has been little or no progress on trade reform. Progress on the removal of exemptions has been limited, and surcharges on certain imports have actually been added. Tariff dispersion is still very high, and it now seems unlikely that the spread will be reduced by the middle of this year, as originally envisaged. I also would like to hear from the staff their views on the government's position that future adjustments to the tariff structure must now be undertaken in the context of membership in the South African Development Community, as this may slow things down.

I have to add that we were also somewhat disappointed that the Parliament has not passed either the Corruption Act or the Code of Ethics for Senior Government Officials legislation. The staff explained why the former was not passed, but it is difficult to see why the Ethics Code has been held up.

We agree with the staff that many of the problems are of a technical nature rather than due to a lack of political will. Overall it is clear that the authorities remain solidly behind the reform effort and committed to it. But it does, I think, go to this question of the HIPC timing—whether in collapsing the second stage we are setting an unrealistic time frame for completing crucial reforms. Nevertheless, I think the body of reforms is there. We agree with the staff's recommendations on the HIPC with regard to the decision point today and the completion point in mid-1999 and the proposed NPV of debt targets.

Going beyond the HIPC-specific issues, I had a number of comments growing out of the Article IV review. First is the savings and investment balances discussed by the staff and the authorities' response. Mr. Yoshimura also raised this issue. We certainly accept the government's argument that war-related destruction has necessitated or has entailed higher investment costs due to the need to rebuild infrastructure really from the ground up. Nevertheless, the very low level of productivity of such investments based on the available data is very troubling. The productivity rates seemed to be very low even when compared to other sub-Saharan African countries. I wonder if the staff could elaborate a little bit on the investment program and where they see room for efficiency gains and what prospects they see for efficiency gains.

We certainly agree with the staff's position that tax and pension system reforms are important avenues for creating the savings necessary to finance Mozambique's continued high investment needs. This argument does not seem to jibe well with the medium-term projections, which show gross national savings rising by only about half a percentage point of GDP between now and 2005, according to Table 9. There are also questions about the larger growth strategy, particularly private-sector competitiveness and export performance. The staff refers to the appreciation of the metical, and I wonder whether the authorities should not be careful to avoid any further real appreciation of the currency.

Also, in light of the need to remove bottlenecks and create a friendly business environment, I thought a little more information would have been desirable, perhaps from the World Bank, on reform of the judicial system, the commercial code, and the application of international accounting and management practices. I do not know whether the World Bank is monitoring this but presumably they are, in the context of the HIPC exercise. We also agree that Mozambique should accept Article VIII status, as it appears that in practice they have already done so.

Just one further point on trade and competitiveness. I note that the authorities have decided to maintain a 14 percent tax on the exports of raw cashew nuts. Is this basically to encourage the development of a cashew processing industry in Mozambique? Are there plans to phase out this tax as the processing industry develops? I certainly am in favor of having more value added in raw material processing in Africa generally. We see country after country which are major exporters of raw products, such as Mali with cotton, but with virtually no indigenous processing industry, which could generate a lot of jobs if it were fully developed.

Also, on the poverty front, we welcome the fact that the authorities will be establishing a national action plan by the end of this year, and we hope that a similarly aggressive approach will be taken with regard to the pension and social security systems. There is a particular problem, of course, growing out of the military demobilization, as mentioned by Mr. Yoshimura, and I wonder whether the Bank is providing technical support in this area.

Finally, as I said before, I think it is very clear that the Mozambican authorities remain committed to the reform effort. They are showing very strong results from their continued dedication. It is quite correct that the multilateral institutions provide debt relief alongside the bilateral creditors, who have made not only an initial effort, but a number of bilateral creditors have made voluntary additional contributions for which they should be commended.

I also agree with Mr. Vernikov that it is very welcome indeed that Russia is sitting on the creditor side of the Paris Club table rather than on the debtor side. They are a valuable member of the creditor community now, and their active cooperation and support in this HIPC effort is absolutely essential. They have indeed responded very quickly in a very short time frame, and they deserve commendation for that.

Mr. Jadhav made the following statement:

We commend the authorities for maintaining an impressive track record of macroeconomic stabilization and structural reform for the past decade or so, despite the protracted civil war. Our chair feels greatly encouraged that the authorities have been successful in accelerating real GDP growth, arresting the inflationary spiral, improving the external current account position, and, above all, maintaining nominal exchange rate stability despite a reduction in net capital inflows. These achievements, which are highly significant, allow us to look to the future with optimism. The minor slippages, as pointed out by the staff, being mainly technical in nature, do not reflect a lack of commitment on the part of the authorities. That said, our chair would like to make a few observations.

Mozambique has a long way to go before its people enjoy a reasonable standard of living. The recent economic gains highlight Mozambique's potential in achieving sustained economic growth. However, long-term policy challenges persist and include poverty alleviation, rehabilitation, infrastructure development, and the provision of improved social services. The external debt problem is acute. The stock of external public and public-guaranteed debt—placed at 283 percent of GDP at end-1997—is exceptionally large, and this debt burden has been a major constraint on the ability of the authorities to address long-term problems. It is to the credit of the authorities that there are no arrears outstanding for program purposes.

In the medium-term context, the authorities need to take concrete steps to diversify its economic base, possibly through strengthening the share of cash crops in agriculture. The availability of sunflower, copra, and cotton offers scope for development of small- and medium-scale units based on these raw materials, which being labor-intensive, can also provide ample employment opportunities. Mozambique is a highly dollarized economy, with the share of foreign currency-denominated deposits in total deposits at 41 percent and the share of foreign currency loans rising significantly. The authorities might want to consider specific policies aimed at de-emphasizing dollarization by developing the money market in domestic funds.

Customs is reported to have been privatized. We would like the staff to clarify whether this has improved customs administration, and whether there is any adequate measure of this improvement. It is reported in Paragraph 18 that customs collection improved despite a decline in imports and tariffs. Does this mean that there was gross undervaluation and leakages earlier? We would like the staff to comment.

The 18.9 percent tax-to-GDP ratio is extraordinarily good for a country with a per capita income of only $90. We do not know how skewed the income distribution is in Mozambique, or whether the tax falls regressively on its population, but we agree with the suggested scope of the proposed VAT.

Finally, we would like to commend the staff and bilateral creditors for their exceptional effort in finding a solution to the uncovered resource gap for reducing Mozambique's debt liability. We are extremely pleased that a satisfactory solution has been found, and we fully support the additional assistance from the Fund of $10 million on a burden-sharing basis. With these words, we support the proposed decisions and wish the authorities all success in their policy endeavors.

The staff representative from the African Department commented that the mission from the Fiscal Affairs Department that had just returned from Mozambique was confident that the VAT could be implemented by end-1998. However, it was extremely unlikely that it would be in place by June 1998, as many of the required preparations—such as publicity and education campaigns and adequate computer systems—would need more time. It might be more prudent to delay implementation until March 1999, as prices tend to be seasonally high at the beginning of each year, and it would be unfortunate if the current year's price rise were blamed on the introduction of the VAT. Also, the VAT exemption for financial institutions was due to technical constraints and the desire for a simple VAT, as it was often difficult to assess the value added of the financial sector. The staff would review the matter more closely.

The proposed cut in the personal tax rate for the highest income bracket had been decided primarily on the basis of the desire to reduce tax evasion, the staff representative continued. The resulting fall in revenue would be only about 0.6 percent of GDP, which would be a modest cost if the result were a more efficient tax system and improved customs administration.

On the issue of the current account, the figures in the current staff report differed from those in previous papers owing to unexpected changes in electricity exports, the staff representative pointed out. Future exports for Mozambique were difficult to forecast, as a number of large-scale projects would be gradually coming on-line, and the timing of these projects was hard to predict. Although a transmission line to South Africa had been completed, no agreement had been reached as to the price of electricity. Exports would be considerably reduced until the parties agreed, and even then the price was likely to be lower than expected.

On the sustainability of Mozambique's performance, the staff believed that the fiscal deficit would have to be reduced, as current levels of foreign aid were unlikely to be sustained over the long term, the staff representative commented. However, Mozambique's current success, relative to other countries in Africa, might attract more funds in the immediate future. It was important to have advance warning from donors, so that projected aid levels could be properly accommodated in the program and the authorities might better target their investment decisions. The authorities were determined to press ahead with their reforms, which, if maintained, would encourage foreign investment and continued high rates of growth.

On the issue of time deposits, there was a sound argument that the reserve requirement should be extended to include time deposits with maturities higher than one year, the staff representative remarked. That recommendation had been made to the authorities, and they were actively considering the measure. However, such a move might prove politically unpopular, so the authorities wanted to be sure that the exemption for more lengthy deposits was being significantly exploited.

Additional waivers would not be needed for the period ending March 1998, because by the time the staff had conducted consultations for the midterm review, the period had already elapsed, the staff representative said. Targets at that stage would have made little sense. The review essentially recorded what had already happened, so that the March 1998 indicators were benchmarks, rather than targets.

In response to a question from the Acting Chairman, the staff representative agreed that current aid levels were very high and that eventually Mozambique would have to rely less on aid and more on foreign investment. The key factor in improving investment was forward planning—so that projects were chosen according to economic criteria, used well-formulated programs, and emphasized high-priority sectors. Also, dialogue with donors on priority sectors was very important. While donors had focused on the social sector, which was critical for long-term growth, they also needed to think ahead for ways in which they could help the private sector, which would prove vital in enhancing the productivity of investment.

Ms. Lissakers noted that the World Bank was working with the authorities to develop a local processing industry through a cashew nut export tax. She wondered whether the Bank and other donors were doing more to foster local processing, and whether microcredit activity might be useful.

The staff representative from the World Bank replied that there had been an ongoing dialogue between the Bank and the authorities on cashew policy reform. Based on that dialogue, the authorities had moved from an effective tax rate of about 40 percent on raw cashew exports to the current statutory level of 14 percent. Household survey data show that the lower tax rate has had a positive impact on the real incomes of smaller farmers. Nevertheless, the matter was a politically charged issue in Mozambique. Responding to these pressures, and in an attempt to foster local industry, the authorities had decided to suspend the program of export tax reduction. The Bank was also working with the authorities on other aspects of cashew policy, including improved husbandry of cashew trees, new plantings, improved productivity, and more modern domestic processing. The latter modernization would take place with the help of a new operation called the Enterprise Development Program, which would also include microcredit aspects. The Bank was also considering whether a wider program of microgrants was warranted.

The Bank fully recognized the need for more efficient investment and the importance of aid coordination, the World Bank staff representative said. There was already considerable coordination among donors and the authorities, and the Bank was working to improve that process. The Bank would soon conduct a local donor retreat in Maputo. The retreat would include bilateral donors, the Fund, and the authorities.

The staff representative from the African Department noted that the Bank had recently sent a mission to Mozambique to discuss civil service reform. A further mission was scheduled for May 1998. While reforms were scheduled for April 1999, much had already been done, and further missions would focus on a more specific timetable. Also, the World Bank had completed a "red tape" study and had since conducted yearly private-sector conferences, in which the authorities were required to explain their progress in removing those obstacles flagged in the previous meeting.

Commenting on Mozambique's pension system, the staff representative said that with so many other issues to consider, the Bank had not yet given this issue detailed consideration. However, the staff of the Fund and the Bank were starting to discuss pensions, and the authorities were extremely interested and forward thinking on the topic.

The law on a code of ethics had been passed by the assembly on the first reading, the staff representative noted. But the anticorruption law was still in assembly and was not likely to be passed. Many assembly members felt that the issue deserved more detailed consideration and that resources would be better spent on a national audit unit and an improved judiciary.

Commenting on Mozambique's improvement in tariff revenue, the staff representative noted that reduced tariff evasion rather than previous undervaluation had resulted in increased revenues. There was much more to be done in reducing tariff rates, and SADC considerations should not be seen as a valid reason to postpone further reductions. The World Bank was hoping to convince the authorities to continue the pace of reform, with studies that highlighted actual effective rates of protection currently applying in Mozambique.

The staff representative from the Policy Development and Review Department commented that, on recent debt reduction negotiations under the HIPC Initiative, he agreed with Mr. Vernikov that the extraordinary action by bilaterals in closing the financing gap should be seen as exceptional, and he joined Ms. Lissakers in wishing to commend the Russian authorities for the speed with which they had acted. The efforts by multilaterals were also exceptional, so that very little in the Mozambican case could be seen as a precedent.

The Acting Chairman joined Ms. Lissakers in commending and congratulating all concerned in closing the financing gap. It was important to stress the ultimate goal of placing Mozambique on a sustainable debt path and arrive at a sensible and practical solution, rather than being bound by narrow technical rules.

On Mr. Vernikov's concern that guidelines under the HIPC Initiative were not generally being followed, the staff representative remarked that, while it was true that the second stage under the initiative had been shortened in the case of Mozambique, in other cases such as Cote d'Ivoire and Guinea-Bissau, the second stage was the envisaged three years. Further, the staff expected that future cases would also have the normal three-year interval between the decision point and the completion point, as envisaged under the general framework.

The African Development Bank would finance between one-third and one-half of its participation through its own net income, and the remainder would come from bilateral contributions to the Bank's HIPC Trust Fund, the staff representative noted. While the World Bank, the IMF, and the African Development Bank were Mozambique's three largest multilateral creditors, it was unlikely that the African Development Bank could contribute further. The final HIPC document assumed additional contributions only from the Fund and the World Bank in closing the financing gap, in proportion to their exposure to Mozambique.

The staff representative from the World Bank said that, with respect to Ms. Lissakers' question on judicial reform, the Bank was working with the authorities on a program of judicial performance and that this was part of a comprehensive review of public-sector reform. The review included not only the civil service, but also issues such as the need for an effective auditor general's office and broader legal reform. A team of consultants was currently working on reform of the commercial code.

Mrs. Guti said that while she appreciated the previous discussion on tax and trade policy issues, it was important to emphasize that the authorities were not lagging behind on their commitments. Mozambique had met all of its promises and was determined to continue on the same path. There had already been substantial progress on reducing tax exemptions, and Mozambique's emphasis on aligning its trade policies with the SADC highlighted the importance of looking at the regional picture when addressing national policy issues. While she would have hoped for an earlier resolution, Mrs. Guti expressed the authorities' thanks to the Russian authorities for their role in helping reduce Mozambique's debt burden. Finally, she noted that the issue of anticorruption reform was one that had taxed and confounded legislatures all around the world. The Mozambique Assembly's caution in addressing this complex issue was therefore appropriate.

Mr. Donecker made the following statement:

> First, a few comments on the ESAF midterm review. On the economic strategy, in particular on the need to reduce the fiscal deficit and the need to improve the productivity of investment, I agree with most of what Mr. Vernikov, Mrs. van Geest, and Ms. Lissakers have said. Just one additional remark: I do not quite share staff's view that "there are valid reasons for the overshooting of the monetary targets, namely unanticipated money demand and the authorities' desire not to unnecessarily slow down growth." In our view, and that will not surprise you, one should better err on the side of caution, and give priority rather to stability-oriented policies thus promoting a sound basis for sustainable high-quality growth than focussing too much on short-term growth. We therefore strongly expect that, for the current year, the monetary targets will be strictly observed. With these remarks I can support the proposed decision on the midterm review.
>
> Secondly, on the final HIPC document, I can agree with the suggested decision point in April 1998. With respect to the completion point, as already indicated during our previous discussion, last September, a completion point in mid-2000, in our view, would have been more appropriate given the rather uneven track record of Mozambique. However, I am also prepared to go along with the Board consensus for a completion point already in mid-1999, provided Mozambique's policy implementation is strong.
>
> We can also agree with the suggested target of 200 percent for the NPV of debt-to-export ratio. In our view, such a low target appears to be appropriate in the exceptional case of Mozambique. This, however, should not preclude considering the full possible target range of 200–250 percent in other cases, as already stressed by Mr. Vernikov.
>
> On burden-sharing, I welcome that, due to exceptional efforts from all parties involved—bilateral as well as multilateral—the residual financing gap

has apparently been closed. Can staff confirm this? I consider staff's supplement, issued yesterday (April 6), as an integral part of today's decision.

We especially welcome the willingness of the Russian authorities to provide additional relief on post-cutoff date debt (5/44). This is very helpful, indeed. In this context, allow me to recall the fact that already in 1993, Germany provided a 60 percent debt relief on post-cutoff date debt in the amount of $16 million, in addition to other substantial financial assistance.

Mr. Pascual made the following statement:

We have before us today two important decisions to make. Both are crucial for Mozambique, and both should depend on our judgment about the authorities' commitment to carry out the wide set of measures addressed to bring the country back to the path of sustainable development after several years of internal conflict and economic difficulties.

We must be confident. The Mozambican authorities have worked hard to accomplish the difficult task of reconstruction. Following the plausible results of 1996, the 1997 economic performance has kept the same praiseworthy trend. Real economic growth has exceeded forecasts, while inflation and fiscal and external deficits have been lower than expected. All but two performance criteria have been met, and even in these two cases there are enough reasons for the authorities to justify the miss. The prudent mix of policies and the determined actions on structural reform have placed the country in a favorable position to take advantage of the international efforts to help countries like Mozambique. Now is the time for creditor and international donors to make an additional effort to place Mozambique on the road of new hope, provided that the authorities maintain the same kind of commitment and prudence shown so far in implementing the policy mix and in addressing the most urgent social needs.

Since overall I share the spirit of the recommendations suggested, the assistance provided, and the assessments made by the staff about Mozambique, I support the proposed decisions in both fields that related to the concession of waivers for the nonobservance of the end-September performance criteria about NDA and NFA of the banking system and that related to the inclusion itself and the conditions of that inclusion in the HIPC Initiative. Specifically:

1. We agree in considering that Mozambique continues to be eligible for the initiative.

2. We agree that Mozambique has reached the decision point.

3. We also agree that so far the efforts made by the authorities vouch for a reduction of the interim period to a completion point in mid-1999, provided, of course, that the reforms and the program remain on track.

4. We could accept that the NPV of debt-to-export ratio be set at around 200 percent and the target for the debt-service ratio at 20 percent.

5. We support the additional contributions by this institution so as to cover the financial gap and to preserve the proportional burden-sharing in the HIPC Initiative. We consider this equitable, fair, and in compliance with the spirit of the initiative. My authorities have committed themselves to keep on working in the same direction. Such is our commitment that we are studying additional alleviation measures following the decision to be taken here today.

To conclude, Mr. Chairman, let me convey my best wishes to the authorities in their endeavors ahead.

Mr. Goffinet made the following statement:

The strong commitment of Mozambique's authorities to growth-oriented policies has borne fruit. GDP growth, aided by good weather, stands at 8 percent; inflation fell well below its target to 4.5 percent; the current account deficit has been reduced; and fiscal and monetary policy have been strengthened. On the structural front, significant and credible progress has been achieved. I can agree to grant waivers for the two missed end-September performance criteria.

It is clear that Mozambique is satisfying the conditions to make itself eligible for assistance under the HIPC Initiative and has reached the decision point.

Bold and steady implementation of the planned economic and structural measures will be the key to durable stability, steady growth, and poverty reduction. Despite a good track record of policy implementation under very difficult conditions, substantial future efforts from Mozambique's authorities will be needed on the way to medium- and long-term stabilization. So although I agree with advancing Mozambique's completion point to mid-1999, the authorities must stick firmly to their adjustment policies. It therefore seems reasonable to link this shortening of the intermediary period conditional on continued strong implementation of macroeconomic policies and structural reforms, especially in the area of social policy, where enormous improvement will be required just to bring Mozambique's social indicators up to the average level for sub-Saharan Africa.

The reform process is also threatened by external and fiscal vulnerabilities. As we already mentioned last September, we believe that Mozambique's debt-to-exports ratio should be set at 200 percent; given Mozambique's pressing need for reconstruction and development, the assistance should be delivered in such a way that the debt-service ratio could be reduced rapidly below 20 percent of exports.

As concerns the sharing of the burden represented by the remaining financing gap of $116 million, in which Belgium participated in a flexible manner with an amount of $1.5 million, I can agree that the Fund should very exceptionally make an additional contribution of $10 million so that agreement can be reached very quickly, as needed by Mozambique, which is one of the poorest countries in the world.

This additional financing, which shows the goodwill of the Bretton Woods institutions in going beyond the fully proportional burden-sharing approach that was agreed upon with Paris Club creditors, should be considered as an exception.

I wish the authorities all the best in their endeavors.

Mr. Zhang Fengming made the following statement:

First of all, my authorities wish to extend their sincere congratulations to the Mozambique authorities on successfully achieving the 1997/98 program objectives. The numbers speak for themselves: the highest economic growth in four years, a single-digit inflation rate that is far below the program target, and a sharply reduced current account deficit in terms of its percentage of GDP. Also, good progress has been reported on structural reforms. I support the staff's recommendations that we complete the midterm review under the second annual arrangement under the ESAF.

It is even more encouraging to learn that the authorities are committed to adhere to the economic program by maintaining prudent fiscal and monetary policies during the run-up to the local government elections. This is crucial for continued success of the future program and for further ensuring the realization of a bright outlook for the medium term.

Now that the policy framework has been worked out, the authorities need to maintain the current momentum and keep up their efforts in pursuit of new program targets. Special attention should be given to monetary targets which fell were off-track last year. As rightly pointed out by the staff, any buildup of excess demand in future economic development, whenever it occurs, warrants prompt action. In addition, the authorities need to remain alert to those remaining long-term problems, such as poverty, rehabilitation, and the expansion of infrastructure. Given Mozambique's situation, it is necessary to explore both financial and technical assistance from outside. However, the authorities should also seek to increase domestic savings, strengthen public-sector institutions, and improve the availability of human capital.

As for the final document on the HIPC Initiative, I agree with the proposed decision.

Finally, we wish the Mozambique authorities continued success in the future.

Mr. Rouai made the following statement:

I support the staff conclusion that Mozambique meets the eligibility criteria for assistance under the HIPC Initiative. Although my preference was for a completion point by end-1998, I agree with the general consensus of a mid-1999 completion point, provided that the country maintains its strong record of adjustment under the third annual ESAF arrangement.

I also support the staff recommendation for an NPV of debt-to-export ratio target of 200 percent and a debt-service ratio target of 20 percent. The international community, including the Paris Club creditors, Russia, and the World Bank, should be commended for the exceptional effort made to ensure full financing of the assistance package for Mozambique.

I welcome the section on medium-term issues that detailed an innovative agenda of needed reforms. I would like to take this opportunity to encourage the authorities to achieve further gains on the fiscal side, to concentrate on promoting efficiency in investment, and to accelerate external liberalization, including trade, tariff reform, and acceptance of the obligations of Article VIII. I support the proposed decision and the additional contribution provided by the Fund to Mozambique.

Mr. Lehmussaari made the following statement:

After many years of struggle, it seems that Mozambique's economy is on the right track. A broad-based economic growth continues, with relatively low inflation and a strengthening external current account.

Despite this positive development, there remain areas of concern which, in the medium run, can endanger the economic development of Mozambique. In this regard I will make a few observations on fiscal policy and the financial side of the economy.

The fiscal sector remains fragile, despite a somewhat better-than-programmed performance in 1997. While the staff indicates that the deficit before the grants is not a performance criteria under the program, a budget deficit in the magnitude of 20 percent before grants poses some question marks, in particular, as it is to a large extent aid-financed.

Large aid flows to Mozambique are expected to gradually decline, as explained in the staff report. This would imply sharp cuts in government expenditures, mainly capital expenditures, in order to keep the overall government deficit at a reasonable level. This drop in investment activity would, in turn, hamper Mozambique's future growth potential. Against this background I am, to some extent, surprised that the government decided, as part of the tax reform, to reduce consumption taxes and average tax rates, and, at the same time, there still seems to be considerable uncertainties in introducing value-added tax (VAT).

Regarding the financial side of the economy, the high level of the spread between the Bank of Mozambique's rediscount rate (of 12.95 percent) and the metical loan rates (that are around 25 percent in end-1997) indicates, in my opinion, that there are substantial inefficiencies within the banking sector in Mozambique. Although the spread can be explained to some extent by high lending risks and a high premium for expected depreciation of the metical, the Bank of Mozambique should take a leading role in developing the infrastructure of money markets in order to improve the functioning of that market. It is also noteworthy that since late 1995 foreign currency denominated loans have increased significantly. Although they represent, at present, only 50 percent of foreign currency deposits, the sharp expansion of foreign currency loans clearly calls for the banking sector's attention to foreign exchange risk exposures. This is even more important if foreign currency loans are extended to medium-sized firms with no or little revenue in foreign currencies.

Regarding the final document on the HIPC Initiative for Mozambique, I have the following comments:

First, we consider Mozambique eligible and qualified for assistance.

Second, I can agree that Mozambique has reached a decision point.

Third, this chair still thinks that a somewhat longer and more realistic time frame for necessary reforms would have been an advantage, but my authorities can also accept the proposed mid-1999 completion point, provided that policy implementation remains strong and structural reform is sufficiently ambitious.

Fourth, we support the target to be set at 200 percent.

Finally, regarding the voluntary contribution required by the IMF to fill the bilateral financing gap, any deviation from adherence to the HIPC Initiative's principle of proportional burden-sharing is most unfortunate and must not set a precedent. As exceptional efforts have been attempted in this case, we accept the Proposed Decision presented in Supplement 1 and the Fund's additional financing at the completion point.

Mr. Elhage agreed that Mozambique had reached a decision point. Although a completion point of December 1998 would have been preferable, he was willing to support the consensus view of a mid-1999 completion point. The NPV of debt-to-export target of 200 percent and the debt-service ratio target of 20 percent were both appropriate.

Mr. Phan made the following statement:

First of all, I would like to thank the staff for the well-informed paper. Following the Board's discussion on the preliminary document in September 1997, the completion of the reconciliation of bilateral debts, including the Russian claims, and the update of the debt sustainability analysis allow us today to make a decisive consideration of the Republic of Mozambique under the assistance of the HIPC Initiative.

As I pointed out in the previous discussion, the Republic of Mozambique remains one of the poorest countries in the world and the poorest in the group of HIPC candidates. Hence, it deserves international assistance for it to exit from the external debt burden following the successful implementation of one SAF and two ESAF arrangements.

It is commendable that all but two objectives of the 1997/98 economic program are being achieved with strong economic growth and low inflation. The external current account has strengthened, and the nominal exchange rate is stable. In addition, fiscal policy is tighter than programmed. All the structural benchmarks for the program are being observed, and the policy reforms contained in the Policy Framework Paper generally are being implemented as expected. However, as pointed out by the staff, the situation is still fragile and much more remains to be done if the Republic of Mozambique is to sustain macroeconomic development over the long term. I, therefore, support the completion of the midterm review.

Given its strong track record, I fully agree with the suggestion that on the basis of the debt sustainability analysis, as contained in the staff paper, the Republic of Mozambique is eligible for relief under the HIPC Initiative and that Mozambique has reached its decision point to eligibly receive interim assistance from the IDA under the HIPC Initiative. In addition, I fully agree with the suggestion that the completion point could be set in mid-1999, provided that implementation of macroeconomic policies and structural reforms under the third annual ESAF arrangement and IDA lending operations remain strong as already indicated in our discussion last September. I would go along with the staff recommendation that the target for the NPV of debt-to-export ratio for Mozambique be set at 200 percent, and that the target for debt-service ratio be set at 20 percent. I would also support the staff's proposal to supplement additional bilateral resources with a combined Bank/Fund contribution of up to one-third of the overall gap. However, contribution of regional development bank is encouraged in burden-sharing.

In conclusion, I wish the authorities every success.

The staff representative from the Policy Development and Review Department confirmed that the gap of $116 million had been closed, as outlined in the supplement to the final HIPC document. The figure of $116 million had been calculated in a slightly different way than in the final HIPC document, as had been explained by the staff representative from the African Department in his opening remark and confirmed by Mr. Vernikov. The action of the Russian authorities was also slightly different in the supplement, but it achieved the same result in terms of the remaining overall debt to the Russian Federation.

Mrs. Guti thanked the Executive Directors and the international community for their support and the staff for their work. Mrs. Guti reemphasized that the authorities remained committed to reform, aware of the challenges they faced, and determined to address these problems squarely.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They noted that the Republic of Mozambique's overall economic performance had continued to improve in 1997, as evidenced by higher growth, falling inflation, an improvement of the external current account, and the stability of the nominal exchange rate. These positive developments had further bolstered confidence, and private investment was on the upswing.

Directors commended the authorities for adhering to their macroeconomic program for 1997/98, as well as for their determined efforts to implement the wide-ranging structural reforms set out in the policy framework paper. Most Directors agreed that the unexpectedly strong money demand and the need to avoid slowing growth had warranted the somewhat higher than programmed monetary expansion, especially as it appeared to have no adverse impact on prices. However, they advised the authorities to closely monitor economic developments and to take quick action to curtail money and credit growth if there are signs of overheating.

Directors noted that, despite the recent economic gains, Mozambique still faced major economic problems, notably widespread poverty, an inadequate social and economic infrastructure, and a heavy external debt burden. They stressed the need for firm adherence to the program, through continued prudent financial management and an acceleration of the remaining structural reforms, in order to consolidate the gains already achieved and to place the economy on a path of strong and sustainable growth.

In this context, Directors endorsed the proposed policy framework for 1998. They observed that the continued heavy dependence on foreign aid indicated a need to raise public-sector savings, boost export growth, and increase financial deepening. Directors welcomed the significant strengthening of tax revenues in 1997 and urged the authorities to maintain or increase the momentum of improvements in tax and customs administration and to broaden the tax base. They recommended an early introduction of a value-added tax, to be accompanied by a public information program. They also urged the authorities to find a satisfactory solution to the problem of pension payments to demobilized military personnel. Directors welcomed the introduction of a new budgetary accounting framework, which would further enhance budgetary transparency and facilitate a reallocation of resources to social programs.

Several Directors stressed that the authorities should pay attention to the efficiency—as well as the level—of investment, the absorptive capacity constraints facing the economy, and the implications of higher investment spending for recurrent costs. They agreed that an improvement in aid coordination would help achieve better resource allocation, and advised the authorities to continue their discussions with donors to resolve the outstanding issues.

Directors welcomed the near-completion of the privatization program and the efforts to restructure the remaining public enterprises. They encouraged the authorities to consider full privatization of the remaining enterprises under the program. They also urged the authorities to give high priority to the reforms of public administration and the pension system.

Directors noted the high level of dollarization of the economy. Directors emphasized the importance of maintaining prudent monetary policies, adequate bank supervision, and a prudent level of gross international reserves. While noting that the evidence on external competitiveness is mixed, Directors cautioned that a further real effective appreciation of the metical should be avoided.

A few Directors were disappointed by the slower progress toward trade reform in the most recent period. The authorities were encouraged to further reduce tariff spreads and exemptions. Directors also suggested that the recently signed free trade protocol with the Southern African Development Community (SADC) could provide an added opportunity to set more ambitious trade reform objectives. Directors also encouraged the authorities to accept the obligations of Article VIII, Sections 2, 3, and 4 within the year.

Directors also considered the final document on the Heavily Indebted Poor Countries (HIPC) Initiative for Mozambique. They agreed that Mozambique is eligible and qualifies for assistance under the HIPC Initiative. The consensus view was that the completion point should be in June 1999, subject to the conclusion of the midterm review under the third annual arrangement under the current three-year enhanced structural adjustment arrangement, and approval of a new three-year enhanced structural adjustment arrangement by that date. They welcomed the exceptional efforts that are to be made by all of Mozambique's creditors in a spirit of equitable burden-sharing. They also agreed that the external debt sustainability target for the net present value of the debt-to-exports ratio for Mozambique at the completion point will be 200 percent and the target of the debt-service-to-exports ratio will be 20 percent. Directors emphasized that access to enhanced debt relief under the HIPC Initiative was conditional upon satisfactory implementation of a strong program of structural reform and actions in the social area.

It is expected that the next Article IV consultation with Mozambique will be held on the standard 12-month cycle.

The Executive Board took the following decisions:

Republic of Mozambique—Decision Concluding Article XIV Consultation

1. The Fund takes this decision in concluding the 1998 Article XIV consultation with the Republic of Mozambique, in the light of the 1998 Article IV consultation with the Republic of Mozambique conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The Republic of Mozambique maintains restrictions on payments and transfers for current international transactions described in EBS/98/57, in accordance with Article XIV, Section 2. The Fund encourages the Republic of Mozambique to apply these restrictions in a liberal manner and to eliminate them as soon as its balance of payments position permits. (EBS/98/57, 3/24/98; Cor. 1, 3/31/98)

Decision No. 11700-(98/41) adopted
April 7, 1998

Republic of Mozambique—Enhanced Structural Adjustment Facility—Review Under Second Annual Arrangement

1. The Republic of Mozambique has consulted with the Fund in accordance with paragraph 2(d) of the second annual arrangement for the Republic of Mozambique under the Enhanced Structural Adjustment Facility (ESAF) (EBS/97/97, Sup. 1, 6/25/97).

2. The letter from the Minister of Finance and the Governor of the Bank of Mozambique dated March 20, 1998, shall be attached to the second annual ESAF arrangement for the Republic of Mozambique, and the letter from the Minister of Finance and the Governor of the Bank of Mozambique dated May 13, 1996, together with its attached memorandum and tables, shall be read as supplemented and modified by the letter of March 20, 1998.

3. The Fund determines that the midterm review specified in paragraph 2(d) of the second annual ESAF arrangement for the Republic of Mozambique has been completed, and that, notwithstanding the nonobservance of performance criteria set forth in paragraphs 2(a)(I) and 2(a)(iii) of the arrangement, the Republic of Mozambique may request disbursement of the second loan specified in paragraph 1(b) of that arrangement. (EBS/98/57, 3/24/98; Cor. 1, 3/31/98.

Decision No. 11701-(98/41), adopted
April 7, 1998

Republic of Mozambique—Initiative for Heavily Indebted Poor Countries—Final Assessment of Eligibility

Based upon the external debt sustainability analysis for the Republic of Mozambique (EBS/97/158, 8/21/97 and EBS/98/66, 3/31/98), the Fund, as Trustee of the Trust for Special ESAF Operations for the Heavily Indebted Poor Countries (HIPC) and Interim ESAF Subsidy Operations (ESAF/HIPC Trust) adopted by Decision No. 11436-(97/10), February 4, 1997, decides:

(i) that in accordance with Section III, paragraphs 1 and 2 of the ESAF/HIPC Trust Instrument (Instrument), the Republic of Mozambique is eligible and qualifies for assistance under the HIPC Initiative as defined in the Instrument;

(ii) that the completion point for the Republic of Mozambique will be June 1999, provided that by then the Fund as Trustee of the ESAF/HIPC Trust shall have approved a new three-year arrangement for the Republic of Mozambique under the ESAF and the first annual arrangement thereunder, and shall have completed the midterm review under the third annual arrangement under the current three-year ESAF arrangement;

(iii) that the external debt sustainability target for the present value of debt-to-exports ratio for the Republic of Mozambique at the completion point will be 200 percent; the target for the debt-service-to-exports ratio will be 20 percent; and the target range for the present value of debt-to-exports ratio will be 190–210 percent; and

(iv) that in accordance with Section III, paragraphs 3(a) and 3(b) of the Instrument, the SDR equivalent of US$104.9 million would be made available by the Trustee to the Republic of Mozambique at the completion point in the form of a grant to permit a reduction in the present value of the debt owed by the Republic of Mozambique to the Fund, subject to satisfactory assurances regarding the exceptional assistance to be provided by the Republic of Mozambique's creditors. This amount shall be committed by the Trustee once these assurances have been received, and the schedule for using the proceeds of the Trust grant by the Republic of Mozambique shall be established, in accordance with Section III, paragraph 4 of the Instrument. At the completion point, in accordance with Section III, paragraph 3(c) of Instrument, the Trustee may adjust the amount of assistance committed. (EBS/98/66, 3/31/98; Sup. 1, 4/6/98)

Decision No. 11702-(98/41), adopted
April 7, 1998

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/98/40 (4/6/98) and EBM/98/41 (4/7/98).

2. DEMOCRATIC PEOPLE'S REPUBLIC OF KOREA—TECHNICAL ASSISTANCE

The Executive Board, with one abstention by the U.S. chair, approved the following decision:

1. By a letter dated February 6, 1998, the government of the Democratic People's Republic of Korea has requested the Fund to provide it with technical assistance.

2. In response to this request, the Fund decides to conduct a one-week workshop on the International Monetary Fund in Beijing for 15 to 20 North Korean officials, subject to appropriate external financing being obtained to cover the cost of transportation and accommodation for these officials.

3. The Fund also decides to organize a training course in economics for North Korean officials at a suitable university or training institute in the Asia region, subject to appropriate arrangements being made and external financing being obtained. (EBS/98/63, 3/30/98)

Decision No. 11703-(98/41), adopted
April 6, 1998

APPROVAL: March 6, 2001

SHAILENDRA J. ANJARIA
Secretary