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**Statement by Mr. Prader and Mr. Jakoby on Republic of Mozambique
(Preliminary)
Executive Board Meeting 07/52
June 18, 2007**

We thank staff for the concise and interesting set of papers and Messrs. Gakunu and Sulemane for their insightful Buff statement. Mozambique's performance under the PRGF arrangement has been very good and the program can be assessed as successful. We support the proposed decisions and welcome the proposal to initiate a follow-up Policy Support Instrument (PSI). We agree with the thrust of the staff analysis and we will limit our remarks to a few points for emphasis.

In the last decade, Mozambique has achieved solid economic growth while maintaining a satisfactory level of macroeconomic stability. Also, the progress made towards the income-related Millennium Development Goals (MDGs) is commendable. The country's good reputation in recent years has contributed to an increase in investor confidence and has enabled further scaling up of foreign aid as indicated by the recent commitments of a group of 19 donors. We are pleased to note that the political institutional set-up is relatively sound and enables sound ownership of development programs. These achievements together with a relatively favorable medium-term outlook create a solid base to deal with major structural challenges.

A main challenge for the authorities is to diversify the production base and to create a sound domestic potential for strong sustainable growth and achieve substantial progress in non-income related MDGs. We note that Mozambique still ranks rather poorly in non-income MDGs as compared to its regional peers. In particular, the education-related MDGs require more attention. Poor performance of Mozambique in this set of indicators is directly linked to the lack of skilled workers and low productivity in manufacturing and other sectors outside megaprojects.

The authorities deserve credit for the prudent fiscal stance in 2006. However, to reach long-term fiscal sustainability independent of potentially volatile aid inflows, the authorities should increase the limited domestic revenue base. The targeted annual increase in tax

revenues of 0.5 percent of GDP is commendable. We welcome the recent approval of new mining and petroleum fiscal laws which are reducing the generous tax exemptions in these sectors. Staff comments on the potential impact of these laws on tax revenues would be welcome.

Besides the continuation of making changes to the tax system as mentioned in the statement of Messrs. Gakunu and Sulemane and further strengthening of tax administration it will be necessary to improve the conditions for the development of small and medium private enterprises. We welcome the strategic action plan that has been drawn up to build the business environment. However, like Ms. Lundsager and Mr. Parodi, we would prefer to see that targets are focused on improving the relevant indicators per se and not on relative international ranking.

In order to reap the fiscal benefits of the ongoing megaprojects in the area of natural resources and to ensure that they will further contribute to poverty reduction, the authorities should step up the application of international best practice in taxation and transparency and also join the Extractive Industries Transparency Initiative.

High real interest rates and lack of collateral has limited the access of businesses to credit. Although we welcome the authorities' efforts to promote microfinance institutions, we urge them to maintain a sound supervisory framework. Continued prudent fiscal policies will be critical in preventing recourse to monetary financing in the future and would free up more resources for private sector credits.

In addition, a prudent fiscal stance will help in preventing the reversal of the current disinflationary trend and improve international competitiveness in the light of scaling-up aid. The size of aid commitments presents a formidable challenge for Mozambique's absorption capacity as rightly emphasized in the Staff Report. In the context of the existing real exchange rate misalignment, competitiveness of domestic products should benefit from the elimination of restrictions on exchange rate movements.

We are pleased to learn that the authorities intend to move toward full current account convertibility following the expected approval of the new foreign exchange law in July. This step will represent a key milestone on the way towards open market economy in Mozambique.