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December 24, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Mozambique—Poverty Reduction Strategy Paper—Annual Progress Report—Joint Staff Advisory Note**

Attached for the **information** of Executive Directors is the advisory note, prepared jointly by the staffs of the Fund and the International Development Association, on the Republic of Mozambique's annual progress report on the poverty reduction strategy paper (EBD/08/115, 12/24/08). At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of the Republic of Mozambique indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Sharer (ext. 36515) and Mr. Staines (ext. 34431) in AFR.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Wednesday, January 7, 2009; and to the African Development Bank, the European Commission, the Food and Agriculture Organization, the Islamic Development Bank, and the Organisation for Economic Cooperation and Development.

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INTERNATIONAL DEVELOPMENT ASSOCIATION AND
INTERNATIONAL MONETARY FUND

REPUBLIC OF MOZAMBIQUE

**Poverty Reduction Strategy Paper—Annual Progress Report
Joint Staff Advisory Note**

Prepared by the staffs of the International Development Association and
the International Monetary Fund

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December 24, 2008

I. INTRODUCTION

1. **In September 2006, Government formally approved its revised Action Plan for Reducing Absolute Poverty (‘PARPA’, the Mozambican Poverty Reduction Strategy Paper).** The revised PARPA 2005–09, referred to as PARPA II, was prepared by Government through broad-based consultations with major stakeholders and civil society in a more participatory approach than PARPA I, involving national and provincial Development Observatories.¹ PARPA II is the operational plan for Government’s Five Year Program (2005–09), and for the first time includes a strategic matrix of key indicators, which is a joint effort by the Government, donors and civil society. These indicators are integrated into and monitored through the annual instruments of the Economic and Social Plan (PES) and the PRSP Annual Progress Report (BdPES), which are also submitted to Parliament. PARPA II was presented to the Executive Boards of Directors of the International Development Association and the International Monetary Fund in November 2006, along with the Joint Staff Advisory Note.

2. **This JSAN reviews the implementation of the PARPA II in 2007, and provides Staffs’ advice for future years.** Government and the direct budget support donors annually review the past year’s program implementation in April, and agree on new commitments for the following year four weeks later. In September, a joint Mid-Year Review agrees on the performance indicators and targets for the following year. These reviews lead to an aide-mémoire that complements the BdPES and the PES. The aide-mémoires of the April 2008

¹ Mozambique has established ‘Development Observatories’ (DO) as a consultative forum for discussion of poverty reduction issues, which includes representatives from Government, civil society, and international partners. The DO is tasked with collecting and analyzing data on poverty, and monitoring the implementation of the PARPA. Provincial DOs are intended to facilitate dialogue and consultation at the decentralized level.

Joint Review and the September 2008 Mid-Year Review have been used as background for this JSAN.

3. **The previous Joint Staff Advisory Note was prepared on the PARPA II in 2006.** Staffs welcomed the strategy to consolidate macroeconomic stability and accelerate the second wave of reforms in PARPA II to facilitate sustained broad-based growth and poverty reduction. Mozambique has made large strides since 2006 in its two-pronged strategy of persevering with the stabilization effort and buttressing the business environment, though staffs urge the authorities to strengthen their efforts in the latter area. As previously urged by staffs, Mozambique has emphasized PFM and public sector reforms to ensure the effectiveness of public spending and to improve public sector governance. As also previously urged by staffs, Mozambique has moved ahead on measures to strengthen the public management of the country's nature resources, including the introduction of a mining fiscal regime and initiating steps to adhere to the EITI.

II. MACROECONOMIC AND FISCAL FRAMEWORK

4. **Staff's welcome the broad coverage of macroeconomic developments in 2007 and the assessment of performance against targets laid out in the Government's Economic and Social Plan for 2007.** Staffs encourage the Government in future assessments to broaden the discussion of the role played by the fiscal sector and donor aid inflows in the overall macroeconomic strategy. A forward looking discussion of the evolving macroeconomic framework would also have been welcome.

5. **During 2007, Mozambique continued to meet the key macroeconomic objectives under its medium-term development plan.²** Its core policy objective is to maintain high and sustainable growth to reduce poverty. Macroeconomic performance during 2007 encountered challenges from extensive flooding and significant increases in international import prices for fuel and food stuffs. However, Mozambique also benefited from higher international prices for its exports and attracted substantial investment capital inflows. As a result and as planned, GDP growth in 2007 remained strong at 7 percent, though somewhat below the 8 percent average annual growth achieved over the previous five years.

6. **Government is committed to its medium-term fiscal strategy to make room for private sector credit by avoiding recourse to domestic financing.** Government has made large domestic debt repayments since 2002, but was unable to make repayments in 2007. This was largely because of the need to fill the gap resulting from shortfalls in external aid (due to donor administrative delays) intended for on-lending to public enterprises (without a corresponding reduction in on-lending), as well as some deficiencies in cash-flow management. Government made strong efforts to increase domestic revenues, which increased by 1 percent of GDP compared to 2006, owing to stronger income and profit tax

² Since June 2007, Mozambique's macroeconomic program has been supported by the IMF with an arrangement under the Policy Support Instrument.

collections. However, Government has continued to encounter difficulties in executing capital expenditures. Moreover, expenditures on ‘priority’ areas declined from 17 percent of GDP and 65 percent of total expenditures in 2006 to about 16.5 percent of GDP and about 61 percent of total expenditures in 2007. Some discussion of how the shortfalls in capital expenditures might be addressed would have been welcome.

7. **The Bank of Mozambique remained committed in 2007 to prudent monetary policy geared towards price stability in the context of a flexible exchange rate.** Overall inflation has continued to trend down, though erratically due to volatile food prices. However, Mozambique had difficulty in meeting the objective of reducing overall inflation to about 6 percent. Climate shocks as well as higher fuel and food import prices pushed overall inflation in the twelve months to December to above 10 percent. Foodstuffs account for over half of the overall CPI basket, and food prices in the two years to the end of 2007 had increased by about one-third. The Bank of Mozambique has nevertheless been able to contain inflationary pressures and, excluding food and energy-related items, inflation has continued to decline, falling below the 5 percent medium-term target for overall inflation. The continued downward trend in underlying inflation has helped continued financial deepening as measured by the rising share of broad money in GDP. Moreover, although weaker than expected, private sector credit increased 17 percent.

8. **Developments in Mozambique’s external position during 2007 were positive.** The adverse impact of higher fuel and food import prices on the current account was more than offset by a sizeable increase in aid and private capital inflows. Aid flows to Mozambique in 2007, at about 13 percent of GDP, were broadly in line with previous years. However, private capital inflows in 2007 approached 6 percent of GDP, substantially higher than in recent years. Large public and private capital inflows helped boost domestic investment but also allowed the banking sector to accumulate substantial external reserves—raising official import coverage to five months (well above the 4 month target)—and underpinned a 6 percent appreciation in the real effective exchange rate.

9. **Staffs note that Mozambique is vulnerable to the global financial crisis and economic slowdown.** Looking ahead, lower import prices will help reduce inflation and likely benefit the trade balance, but lower export volumes and reduced private capital inflows are expected to reduce economic growth. The turbulence could also spread to the financial system despite its limited integration into global financial markets. The authorities will need to monitor international and domestic developments closely and respond decisively if necessary.

III. POVERTY SITUATION

10. **Mozambique has made significant strides in reducing poverty over the past 16 years, following the conclusion of the civil war in 1992.** Household survey data indicate that the national poverty headcount fell from 69 to 54 percent during 1997–2003. Reduction

in rural poverty was more pronounced, although the proportion of rural poor remained higher than the urban poor. The next household survey, not due until 2009, will show whether poverty has continued falling.

11. Other studies carried out in 2007, however, suggest a worsening of the socio-economic inequalities, and a significant vulnerability of the poorest strata of society.

The 2007 poverty assessment suggests that poverty and inequality may actually have increased in recent years, based on the analysis of the agricultural panel survey data (TIA 2002–05), but highlights that this preliminary result may also be related to the impact of the drought in 2005. Several qualitative assessments have suggested that there has been a recent increase in poverty and inequality, particularly in urban areas. The recent dramatic increases in world agricultural and fuel prices may set back at least some of the gains achieved during the past decade. Staffs note that the 2007 BdPES refers to this development in passing, but does not give it the appropriate prominence or investigate its causes. Notably, the BdPES could have included an in-depth discussion of challenges toward poverty reduction in Mozambique in recent years, despite continued strong economic growth. In addition, in view of the volatility and latent upward pressures on the prices for food products in the international market, Staffs encourage Government to strengthen measures to protect the most vulnerable strata of society.

12. In Staffs' view, annual reporting broadly provides adequate information on PARPA implementation progress, but additional efforts are required to improve the mechanisms for poverty monitoring, as well as to continue developing transparent mechanisms for the allocation of public resources for strategic objectives. Progress was made in relation to the institutionalization and quality improvement of the Development Observatories, and improving the structure of the PES and BdPES. Also, the five-year statistical master plan of the National Institute of Statistics was approved in 2007. Staffs note that additional attention should be given to improving the alignment between the PES and the BdPES, improving the program of statistics on the household surveys, rationalization of the agricultural statistical system, the conclusion of the Orientation Guide for the Development Observatory (OD), and the strengthening of the Civil Society's capacities. Staffs also welcome the progress made in strengthening the Medium Term Fiscal Framework (MTFF), and the piloting of program budgeting, and encourage Government to use these instruments to more deliberately to provide a budget profile directed towards poverty benefiting the more vulnerable population, and taking into account the gender issues. This will help ensure that resources spent have maximum impact on reducing poverty and benefit the most vulnerable people.

IV. PUBLIC FINANCE MANAGEMENT

13. Progress in public finance management has been good, notably in the roll-out and use of e-SISTAFE, revenue collection, implementation of the procurement reforms, and strengthening of internal and external auditing. In general terms, public financial

management showed progress in 2007, through a better coverage and structuring of the Budget Execution Report (BER) 2007; the increase of the inclusion of own revenue in the State Budget (OE), the strengthening of the MTFF 2008–2010, and the implementation of program budgeting in three sectors of the State Budget 2008. The impact of e-SISTAFE became more visible with the conclusion of its roll-out and the use of direct budget execution. Staffs encourage Government to build on this progress by integrating the payroll, pensions and external funds into the direct execution procedure, as well as strengthening applications at the decentralized level.

14. Performance in revenue reforms was also positive, and Government's target to increase total State revenue by 0.5 percent of GDP annually was exceeded in 2007.

Improvement was observed in the reduction of tax evasion, the management of VAT refunds, and the simplification of fiscal and customs procedures. The main challenges are improvement in budgeting and accounting of own revenue, the broadening of the revenue base, and the management of accumulated debts associated with VAT payments for externally funded projects.

15. Government has made good progress in procurement and auditing reforms in 2007. In procurement, Government completed creating, staffing and making operational a total of 472 Units for the Management and Execution of Acquisitions (UGEAs), at central, provincial and district level; the training of technical staff; and an improved coverage of the activities of the Central Procurement Supervision Unit (UFSA). Government has also recently carried out an assessment of the procurement process using the OECD/DAC methodology and the results have been translated into an action plan to further enhance the national procurement system. In Internal Audit, efforts were made to improve of the inspection capacity of the Internal Control Units through the recruitment and training of technical personnel for the sector inspectorates and the completion of the Basic Auditing Manual. The number of concluded auditing reports was 130 in 2007, which constitutes a 25 percent increase compared to 2006. In External Auditing, there were significant improvements in the scope and quality of analysis contained in the report and opinion of Mozambique's Supreme Audit Institution (*Tribunal Administrativo*, TA) on the General State Accounts (CGE) for 2006, due to the strengthening of TA capacity, and an increase in the number of financial audits conducted by the TA (a total of 281), representing an increase of 115 percent. Staffs encourage Government to improve the public access to the judgments of the TA and to the Report and Opinion on the CGE, simplify the direct connection of the TA to the e-SISTAFE network, and ensure the follow up of audits, including the payment of fines.

16. Staffs urge Government to develop a new public financial management strategy outlining key priorities for the next few years. In order to realize the benefits from the reforms which have been started, it will be critical to consolidate the procurement reforms, deepen the SISTAFE reforms, strengthen the instruments for the strategic allocation of resources, and improve the systems of internal control, financial records and accounting. To

these ends, Government has committed to develop a public finance management (PFM) strategy, with a prioritized implementation action plan, building on the main findings and recommendations of the 2008 PEFA report,³ as well as the 2008 ROSC on fiscal transparency, and the forthcoming assessment of procurement systems (CPAR).

V. GOVERNANCE

17. **Progress was observed in the justice sector, although delays persist in finalizing some legal instruments to improve access to justice.** Important legal instruments for the judiciary organization were approved, namely the Judiciary Organization Law and the Organic Law of the Public Ministry. Also, there was an increase in the number of verdicts compared to the previous year and in the coverage of free legal assistance. However, Staffs note that the legislative program concerning legal instruments aimed at improving the access to justice, such as the Penal Code, the Penal Process Code, the Legal Costs Code, the Law on the National Legal Aid Institute (IPAJ) and the Law on Community Courts, continues to be delayed.

18. **It is difficult to analyze the status of implementation of the national and sector anti-corruption strategies.** Progress was made in reorganizing the Central Anti-Corruption Office and the corresponding provincial offices by clarifying their institutional mission and hiring specialized human resources. In order to improve the monitoring of the Anti-Corruption Strategy, the responsibilities of the extinct National Anti-Corruption Forum were transferred to the Inter-ministerial Commission on the Public Sector Reform (CIRESP), which has the function of monitoring the whole Public Sector Reform, and to the Development Observatory as the permanent mechanism of dialogue and consultation between the Government, civil society and cooperation partners.

19. **Staffs encourage Government to demonstrate stronger efforts in the fight against corruption.** Staffs urge Government to accelerate the implementation of the measures and strategies mentioned above, taking into account that corruption constitutes one of the main constraints to the development of the business environment, and the sentiment expressed by the development partners that faster progress is needed in the implementation and application of these instruments. Moreover, there is a need to adjust the national law in accordance with the ratified International Conventions, and to clarify how the courts may apply them. In this context, Staffs share the view expressed by development partners on the need to eliminate the perception of impunity at higher levels, and to avoid the potential conflict of interest between public officials' responsibility and their commercial interests. Staffs also highlight the need for Government to elaborate and/or improve the existing mechanisms for collection and analysis of information, as a way to monitor and assess the effects of these reforms in the life of citizens.

³ An assessment of Public Financial Management completed in 2008 using the standardized PEFA methodology and covering the period between 2004 and 2006, shows that significant quality improvements were made in PFM during this period.

VI. HUMAN DEVELOPMENT

20. **There was progress in the health sector in 2007, but the increasing spread of the HIV/AIDS pandemic continues to undermine the development of the country.** The Ministry of Health took steps to improve its public finance management. However, delays in disbursements of donor funds negatively affected some of the planned activities, notably the training in Obstetric Care and the provision of antiretroviral therapy (adults and pediatric), the expansion of health network and the acquisition of equipment.

21. **The performance of the education sector was positive.** Progress was observed in the implementation of the Strategic Plan for Education and Culture (PEEC). The net enrolment rate of 6-year old girls reached 70 percent against the planned 67 percent. The targeted completion rate for girls (27 percent) was slightly exceeded. However, the pupils per teacher ratio stayed at 73:1 instead of the planned 71:1. Staffs concur with Government that the main challenges lie in improving the quality of education, facilitating a sustainable expansion of post-primary education, and building capacity for program management, in particular at the decentralized level.

22. **The water and sanitation sector well exceeded its targets for 2007.** The number of newly constructed, scattered water sources was 1,529 against 1,055 planned. The coverage rates also showed a substantial increase with rural and urban coverage increasing to 49 percent and 40 percent respectively; the number of people with access to safe drinking water increased to 9.9 million; and the sanitation coverage increased to 47 percent in the urban areas and to 39 percent in rural areas. Within the decentralization framework, the sector defined the new role for each level of Government and initiated a process of decentralizing the funds to the districts and provinces. A Performance Audit of the sector was carried out during 2006/2007, which highlighted a few problems, notably the level of pending VAT reimbursements, weak financial management, and the lack of reliable data on the execution of external funds, among others. The sector prepared an Action Plan based on this audit, and is implementing measures to improve the situation.

23. **In general, the performance of the social protection sector was positive.** A total of 143,000 people received assistance through the various social protection programs (Food Subsidy Program; Direct Social Support; Social Benefits through Work, Income Generation and Community Development), which is 19 percent above the 2007 target. In relation to the Food Subsidy Program, the levels of cash transfers were increased (from 70MT to 100MT as the minimum level and from 140MT to 300MT for the maximum level), and the number of branches of the National Institute for Social Protection (INAS) was increased from 19 to 30, allowing beneficiaries closer access to the services.

VII. ECONOMIC DEVELOPMENT

24. **The abundance of natural resources in Mozambique raises the need to strengthen the management of natural resources and to develop the legal framework to**

improve the selection, negotiation and monitoring of projects and investments. In this context, the revision of the fiscal regime for mineral and petroleum concessions to improve the fiscal contributions of these sectors was a positive achievement in 2007. However, Staffs note that to maximize the benefits for the communities and for the country, it is necessary that the concessions for the projects be granted in a transparent and competitive way, in accordance with the existing legal framework. Staffs also note the opportunity to maximize multi-sectoral policy and operational interventions as a means to capitalize on potential cross-sectoral synergies, such as for instance the synergies between water resource management with hydropower generation, irrigation and flood control.

25. **Several of the 2007 targets for the agricultural sector were not meet.** Notably, the number of hectares of irrigation systems constructed and/or rehabilitated with public funds was only 88 percent of the target, and the percentage of land title requests processed within 90 days was only 52 percent of the target. During 2007, the Rural Development Strategy and the Green Revolution Strategy were approved, followed by the approval of the Food Production Action Plan in 2008. These strategies aim to increase the provision of public agricultural services and financial services, as well as improving the allocation and rationalization of resources, in order to boost agricultural production. Staffs agree with the importance to expand the provision of agricultural services, and that there is a need to increase financial and human resources for the agricultural sector. Staffs also note, however, that more emphasis in the new strategies could be given to the economic justification for these investments, and that the rationale behind some of the proposed measures could be better clarified by identifying the exact source of the market failure.

26. **Progress in improving the business environment for private sector needs to accelerate.** After improving by six positions in 2007, Mozambique's Doing Business ranking decreased by two positions in 2008, reflecting the fact that other countries have improved their business environment faster than Mozambique. Staffs note that very limited access to finance (illustrated by the fact that more than 90 districts have no commercial banks) and high costs of financial services continue to constrain the growth of the productive sector. The low level of infrastructure also continues to restrict the growth of the private sector. Moreover, the private sector considers corruption and criminality factors that influence negatively their performance.

27. **Staffs urge Government to continue to improve the environment for the development of the private sector.** For instance, the following actions could be carried out: (i) elimination of the minimum capital requirement, in the creation of a company; (ii) gradual elimination of the pre-shipment inspections, in coordination with the creation of domestic customs capacity; and (iii) merger of the procedures in the process of obtaining construction licenses (request of the Land User Right ('DUAT'), request of the topographical map, and the authorization for construction).

VIII. CROSS-CUTTING ISSUES

28. **The epidemiological data collected in 2007 revealed that the prevalence rates of HIV/AIDS continue to rise, especially in the south of the country.** Although important progress has been achieved, notably in treatment, Staffs note that much more will have to be done to expand the scale of the national response, and improving its quality and effectiveness, especially for prevention. Particular attention must be given to the approach to HIV/AIDS in all sectors. In this context it is also important that all sectors review their approach to social protection in relation to orphaned and vulnerable children.

29. **Government intervention was effective in mitigating the impact of climatic shocks in 2007.** In relation to natural disasters, the Government continues to concentrate its efforts in implementing the Master Plan for Prevention and Mitigation of Natural Disasters, as initiated in 2006. The year 2007 was characterized by the occurrence of a series of environmental shocks (floods, cyclones and drought). The floods exceeded the record 2001 levels, but due to the timely preparations and intervention by the Government, the human impact was minimized. However, the environmental shocks significantly affected food security, reducing the physical and economic access to foodstuffs for the most vulnerable households. While congratulating Government for the progress achieved, Staffs note the need to continue to improve the coordination, during the planning phase, among different governmental sectors and cooperation partners, which intervene in the implementation of the Master Plan for Prevention and Mitigation of Natural Disasters. Taking into account Government's limitations, improved mechanisms should be found for financing the National Contingency Plan. Moreover, improvements need to be introduced into the resettlement process, and mechanisms identified for the creation of a National Disaster Fund that that would address both the ex-ante and ex-post needs (i.e., disaster prevention, relief and recovery) and include systems and/or mechanisms for the risk transfer.

30. **Increased coordination in environmental management is required to ensure sustainable development.** In 2007 two fundamental instruments for the environment were approved: the Environmental Strategy for the Sustainable Development of Mozambique, and the Law of Spatial Planning. However, difficulties remain for the implementation of these instruments. It is essential that the Ministry of Environment (MICOA) becomes more active in strengthening the coordination between sectors and promoting the use of instruments such as Strategic Environmental Assessments for the sector programs, in order to guarantee the integration of the environmental agenda into the sector plans and programs. The National Plan for Adaptation to Climate Change (NAPA), which was also approved in 2007, needs to be circulated widely and integrated into sector, provincial and district plans. In order to improve the inter-sectoral coordination and collaboration in the environmental area, MICOA will continue to promote the functioning of Environmental Units in sectors and companies that are involved in the exploitation of natural resources.

31. **There was growing recognition of gender issues in 2007.** The production of a study on women's contribution to economic growth, the development of protocols for the provision of medical aid to victims of violence, the dissemination of the Gender Policy and corresponding implementation strategy, the elaboration of the National Plan for the Advancement of Women, and the creation of the District Councils for the Advancement of Women (CDAM) represent important opportunities for gender equity and respect for the human rights of women. The performance analysis of different sectors showed an improvement in the approach to previously identified concerns as reflected by the effort to include women in literacy programs, better provision of obstetric care, and increased geographical coverage of the Offices for Assistance to Victims of Violence. However, the challenge remains of giving greater visibility in the different sectors to gender equality. Staffs also note that the continued lack of gender disaggregated data makes it difficult to analyze the impact of government policies and programs on the respective genders.

IX. CONCLUSIONS

32. **Staffs agree with Government's broadly positive assessment of performance in several areas of the implementation of the PARPA II during 2007, but note the need to give priority to the following issues:** (i) *Improvement of the mechanisms for allocation of public resources to strategic objectives.* The various planning instruments (MTEF, program budgeting) need to be used more deliberately to provide a budget profile directed towards poverty benefiting the more vulnerable population, and taking into account the gender issues. (ii) *HIV/AIDS prevention:* There is a need to increase the scale, the quality and effectiveness of the national response, based on a revision of the current strategy. (iii) *Maximizing the benefits from natural resources:* There is a need to strengthen the capacity for selection, negotiation and monitoring of the projects and investments, as well as the legal framework for public-private partnerships, in order to maximize the benefits from the country's natural resources (minerals, petroleum, hydropower, forestry, and agriculture, among others). (iv) *Economic development in rural areas:* This can be strengthened by giving more attention to small and medium-size firms, stimulating and creating synergies between the primary sectors (agriculture, forestry, fisheries, aquaculture) and tourism, improving the coordination of policies and investments in economic and social infrastructures, and increasing the provision of public agricultural and financial services. (v) *Anti-Corruption Strategy:* Government needs to demonstrate stronger efforts in the fight against corruption and eliminate the perception of impunity at higher levels. There is also a need to avoid the potential conflict of interest between public officials' responsibility and their commercial interests. In addition, there is a need to establish an adequate monitoring system that regularly produces data on the administrative measures in public service, as well as the cases taken to court, and to adjust the national legislation to the ratified international conventions.