

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

**FOR
AGENDA**

EBS/89/27

CONFIDENTIAL

February 22, 1989

To: Members of the Executive Board

From: The Secretary

Subject: People's Republic of Mozambique - Request for Third Annual
Arrangement Under the Structural Adjustment Facility

Attached for consideration by the Executive Directors is a paper on the request by Mozambique for the third annual arrangement under the structural adjustment facility. A draft decision appears on page 18.

This subject, together with the policy framework paper for Mozambique (EBD/89/58, 2/22/89), will be brought to the agenda for discussion on a date to be announced.

Mr. R. Williams (ext. 7643) or Mr. Abdi (ext. 8517) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

PEOPLE'S REPUBLIC OF MOZAMBIQUE

Request for Third Annual Arrangement
Under the Structural Adjustment Facility

Prepared by the African Department and the
Exchange and Trade Relations Department

(In consultation with the Fiscal Affairs, Legal, and
Treasurer's Departments)

Approved by Mamoudou Touré and H.B. Junz

February 21, 1989

I. Introduction

In the attached letter to the Managing Director, dated February 21, 1989, the Minister of Finance of Mozambique has requested the third annual arrangement under the structural adjustment facility (SAF) in an amount equivalent to SDR 8.24 million (13.5 percent of quota), in support of an adjustment program for 1989. The three-year arrangement under the SAF and the first annual arrangement thereunder, for an amount equivalent to SDR 12.2 million (20 percent of quota), were approved on June 8, 1987, and the second annual arrangement, for an amount equivalent to SDR 18.3 million (30 percent of quota), was approved on March 30, 1988. Mozambique has not made use of the general resources of the Fund; accordingly, total outstanding use of Fund resources would amount to SDR 38.7 million (63.5 percent of quota) upon disbursement of the loan under the third-year arrangement. The economic program in support of which the authorities have requested the third annual arrangement is described in the attached letter, and in the revised and updated policy framework paper (PFP) covering the period 1989-91. The updated PFP, prepared by the authorities in collaboration with the staffs of the Fund and the Bank, was circulated to the Executive Board of the Fund on February 22, 1989 (EBD/89/58). It was circulated to the Executive Board of the World Bank on February 23, 1989, and is expected to be considered by the Committee of the Whole on March 14, 1989. Discussions on the 1989 program and the revised PFP took place in Maputo during December 3-16, 1988. ^{1/}

^{1/} The Fund staff team comprised Messrs. R. Williams (head), A. Abdi, J. Simpson (all AFR), A. Wolfe (EP-ETR), and Ms. I. Almeida (secretary-BLS). Mr. A. Coudie, Ms. J. Armitage, and Ms. D. Gressani of the Bank staff participated in the discussions relating to the PFP. Mr. A. Faria of the Office of the Executive Director for Mozambique attended some of the policy discussions.

The staffs of the Fund and the World Bank have cooperated closely in assisting the Mozambican authorities in the formulation of the adjustment and rehabilitation program that has been under way since 1987. The World Bank has provided Mozambique with two IDA rehabilitation credits of SDR 45.5 million and SDR 69 million, each with co-financing. A third IDA rehabilitation credit is scheduled to be considered by the Bank's Executive Board in April 1989. Summaries of Mozambique's relations with the Fund and the World Bank are provided in Appendices I and II, respectively.

The last Article IV consultation with Mozambique was concluded by the Executive Board on November 23, 1988; the staff report (SM/88/227, 10/21/88) provides a detailed review of policy implementation and the performance of the Mozambican economy under the first and second annual arrangements under the SAF in 1987 and 1988, respectively. Accordingly, the discussion of the economic background and developments under the previous SAF arrangements in the following section is limited to a brief overview and summary.

II. Background and Performance Under the First and Second Annual SAF Arrangements

The Mozambican economy experienced a marked and sustained decline in output and major financial imbalances during the first half of the 1980s. These developments resulted from adverse factors, notably the impact of an insurgency that disrupted production and damaged infrastructure, and inadequate domestic policies. Between 1980 and 1986, overall production fell by about 30 percent. Moreover, despite widespread price controls, the recorded rate of inflation rose to about 40 percent in 1986 and extensive commodity and currency parallel markets emerged. Government revenues declined in nominal terms in 1982-85 and the overall budget deficit, which was contained only by a reduction in capital outlays, was financed increasingly by bank credit. Domestic credit and domestic liquidity more than doubled as the banks also granted open-ended financing of the public enterprises' operating losses. In the external accounts, exports fell by nearly 75 percent and imports were reduced by more than 30 percent, capital inflows dropped sharply, debt service obligations mounted, net foreign assets were virtually exhausted, and substantial external payments arrears were accumulated.

At the beginning of 1987, the authorities adopted a comprehensive economic rehabilitation program (ERP) aimed at reversing the economy's long-term decline, reducing external and internal financial imbalances, and establishing the conditions for sustainable economic growth once the security situation was alleviated. The program, supported by the first and second annual SAF arrangements, focused on measures to improve price incentives and increase reliance on market signals relative to centralized administrative controls. Other measures included the introduction of appropriate demand management policies and structural reforms in key

economic sectors. In particular, significant adjustments were made in the exchange rate and administered prices: the value of the metical was adjusted downward from Mt. 39 to Mt. 404 per U.S. dollar in 1987. ^{1/} In 1988 the metical was again devalued, in three steps from Mt. 404 per U.S. dollar in January to Mt. 626 per U.S. dollar in October, and adjustments were made in administered prices to allow for full pass-through of the devaluation. However, the planned reduction to a 30 percent differential between the official and the parallel market rates was not achieved, as the parallel market rate depreciated markedly during a short period and became increasingly unstable. As of end-1988 the official rate of Mt. 626 per U.S. dollar was equivalent to 52 percent of the reported parallel market rate of about Mt. 1,200 per U.S. dollar.

The fiscal program for 1988 focused on containing the budgeted current account deficit by strengthening the revenue base and limiting the growth of current expenditure. Preliminary estimates of the budgetary outturn for 1988 indicate that total revenue increased somewhat more than anticipated, with a growth in nontax revenue collections compensating for an unexpectedly lower rise in consumption taxes and import duties. Current expenditure was also marginally higher than the program's projection, with interest payments and defense expenditure exceeding budgeted allocations and other recurrent expenditure being somewhat lower than targeted. Consequently, the target for the current account deficit (Mt. 35 billion) was attained. Development expenditure was significantly lower than budgeted because disbursement of foreign loans and grants was below projected amounts. Nevertheless, as a result of the lower-than-expected increase in nominal GDP, the ratio of the overall deficit (after grants) to GDP amounted to 14.2 percent in 1988, compared with 11.8 percent in the preceding year (Table 1). Excluding the direct net impact on the budget of the exchange rate adjustments in 1987 and 1988, the overall deficit, after grants, would have declined to 7.5 percent of GDP in 1987 and to 7.1 percent of GDP in 1988, from 15.3 percent in 1986 on an equivalent basis.

The monetary and credit program in 1988 aimed at restraining expansion of banks' assets in line with financial savings flows through the banking system while permitting sufficient credit for economic recovery. Credit and monetary developments were well within the programmed ranges. The benchmarks on total net domestic bank credit were fully observed in 1988. The quarterly benchmarks for bank credit to the Government were observed for the last three quarters of the year, after having been exceeded slightly in the first quarter. Total domestic credit increased by 39 percent (Mt. 85 billion, equivalent to 50 percent of the stock of broad money at the beginning of the period), and net foreign assets, inclusive of deposits held at the Bank of France to meet obligations to the Paris Club, rose significantly. Broad money expanded in 1988 by 38 percent, or by somewhat less than nominal GDP growth

^{1/} The references throughout are to the midpoint between the buying and selling rates.

(about 44 percent), as planned. In 1988, the implementation of financial system reforms was continued, with greater emphasis being placed on the timely payment of interest charges on bank debt by all borrowers. Furthermore, the interest charged on government debt was increased from 3 percent to 8 percent in order to bring it closer to the rate of interest charged to other borrowers. In addition, the process of introducing a new accounting system to the banks and the separation of the central banking and commercial banking functions of the Bank of Mozambique were advanced in the course of the year.

Balance of payments developments in 1988 are estimated to have been broadly in line with the program targets. Revised estimates based on the data for the first three quarters of the year indicate that the current account deficit was somewhat smaller than anticipated under the 1988 program, primarily as a result of a lower deficit in the services account. ^{1/} Moreover, imports increased (22 percent) by somewhat less than expected, reflecting lags in the disbursement of official import support assistance, particularly in the first half of the year. Total official grants and loan disbursements amounted to US\$681 million, and were slightly below the level programmed as a result of lags in commitment and utilization. Accordingly, the overall balance of payments deficit now estimated at US\$470 million, or about US\$20 million lower than initially programmed, was financed primarily by debt relief. Gross official international reserves, targeted to be unchanged for the year, increased by US\$29 million, which was totally attributable to a rise in deposits held at the Bank of France to meet obligations to the Paris Club; excluding such deposits, reserves declined by US\$8 million.

In 1988, Mozambique continued to make progress in regularizing its relations with creditors. Agreements on debt rescheduling, which covered debt service obligations totaling US\$437 million, were reached in principle with London Club banks in May 1987, with Paris Club creditors in June 1987, and with some other creditors in 1988. By the end of 1988 the Government had concluded bilateral agreements with several Paris Club creditors, and formal conclusion of other bilateral agreements was expected to take place in the first quarter of 1989. In keeping with its obligation under the 1987 agreement in principle with the Paris Club creditors, Mozambique has kept fully current in making escrow deposits with the Bank of France; the deposit balance peaked at US\$56 million in late 1988. Conclusion of the agreement with the London Club creditors has been delayed, owing in part to difficulties in data reconciliation, but discussions are continuing.

^{1/} In comparison with program projections, lower merchandise export earnings and continued difficulties in transportation, with a reduction in traffic from South Africa only partially offset by increases from other neighboring countries, are estimated to have been more than compensated for by higher workers' remittances and lower interest payments.

The economic measures and reforms implemented in 1988 had a significant impact on the economy; GDP growth is estimated at about 4 percent. Despite some problems of drought and insecurity, marketed output of food crops grew by 15 percent, while aggregate agricultural marketed production grew by more than 5 percent. Industrial recovery was adversely affected in early 1988 by the inadequate flow of spare parts and productive inputs, but in the latter half of the year production revived, allowing for a modest growth for the year as a whole. Meanwhile, the recovery of domestic production and the increased aid flows made possible a rise in per capita consumption and in investment levels. The rate of increase in consumer prices in 1988 decelerated sharply and amounted to about 50 percent (year-over-year), compared with 163 percent in 1987. Policy adjustments implemented under the program, particularly the exchange rate changes, the decontrol of prices of many consumer products, and the substantial reduction in consumer price subsidies, contributed to the price rise in 1988; prices of commodities in the parallel market declined by about 3 percent, whereas prices in the official markets almost doubled. General wage adjustments were granted in April and October 1988, with the first adjustment skewed in favor of low-income categories; the average increase in wages was in line with the rate of inflation.

The quantitative benchmarks under 1987 and 1988 SAF programs were observed as shown in Table 2. Performance in relation to the structural benchmarks is summarized in the matrix attached to the updated PFP. Implementation of some structural reforms under the 1988 program, notably the first phase of the enterprise reforms and the tariff simplification, required more time than initially anticipated. To the extent that there were delays in the formulation of these structural measures, and therefore in their implementation, this is mainly attributable to the constraints imposed by the limited availability of the requisite skills in the civil service, and to the difficulties in putting in place the needed external consultants.

III. The Economic Program for 1989-91 and the Third Annual SAF Arrangement

1. Objectives and strategy

The Government's economic objectives and strategies for the period 1989-91 are outlined in the policy framework paper (EBD/89/58). The principal economic objectives for 1989-91, which are consistent with those established under the original SAF arrangement, are: (a) to sustain positive growth rates of real GDP of 4-5 percent per year and to improve the level of income and consumption for all the population, particularly in the rural areas; (b) to reduce the rate of inflation, from an estimated 50 percent in 1988 to about 30 percent in 1989, 15 percent in 1990, and 10 percent by 1991; and (c) to strengthen the balance of payments and external reserves and re-establish orderly financial relationships with trading partners and creditors. To achieve these

objectives, policy measures and institutional reforms will be implemented and modified as necessary during the 1989-91 program period. Besides the continued implementation of appropriate policies, the authorities' view is that attainment of these objectives also depends on the support of the international community through the provision of financial assistance at concessional terms and through a reduction in the debt service burden.

The Mozambican authorities' strategy for attaining these objectives focuses principally on reviving the productive base of the economy, notably the private and efficient commercial farming activity in the agricultural sector, where the potential for growth is highest. Agricultural output and its commercialization will be enhanced through the restoration of price incentives to producers by shifting the internal terms of trade in favor of agriculture, the provision of adequate inputs and incentive goods, the rehabilitation of infrastructure, and the phasing out of administrative controls. Additionally, the strategy will facilitate the recovery of industrial production by increasing the supply of agricultural products and of imported inputs essential for rehabilitation and production. To implement this strategy the authorities will continue in the course of 1989-91 to: reduce the centralized administrative controls progressively and encourage more private sector participation; increase reliance on market price signals for resource allocation rather than direct administrative intervention; and improve public resource management so as to ensure that the public expenditure program focuses on the priority requirements of the economy.

The constraints and obstacles faced in pursuing the established objectives include the difficult security situation, which is assumed to remain essentially unchanged, a high level of population growth, and the shortage of technical and skilled manpower, which is expected to be protracted. Despite these serious constraints, the authorities are determined to carry out the medium-term program detailed in the PFP and are committed to implementing the policies and structural reforms summarized below in order to achieve the program's targets.

2. Policy measures and structural reforms

a. External sector policies

Under the 1989 program, the authorities will continue to reduce the scope of parallel markets and to improve the efficiency of the tradable goods sector through flexible management of the exchange rate. The official exchange rate was adjusted on January 1, 1989, such that the metical was devalued to Mt. 652 per U.S. dollar, which has brought the cumulative depreciation of the metical in foreign currency terms to 30 percent since January 1, 1988; the currency was further devalued to Mt. 670 per U.S. dollar on February 3, 1989. During 1989, the Government will continue to implement its flexible exchange rate policy through more frequent, smaller adjustments of the nominal official exchange rate, with a view to achieving a moderate real effective

depreciation. The path of the adjustment will be monitored quarterly and the necessary corrections to attain the real effective depreciation will be made in light of actual price developments in Mozambique and its principal trading partners. In addition, the authorities will conduct a midyear review to determine what, if any, adjustments in this path appear necessary to achieve the 1989 program objectives, which include a significant narrowing of the gap between the official and parallel market exchange rates and a reduction in reliance on the administrative allocation of foreign exchange.

The substantial realignment of the exchange rate since the beginning of 1987 has provided a basis for the introduction of measures to liberalize the trade and payments regime. Accordingly, beginning in April 1989, the Government will introduce a limited system for the nonadministered allocation of foreign exchange; initially the scheme will cover a range of imported inputs--spare parts for transportation, agriculture and construction, and key inputs for the garments and shoe industries--for which import licenses and foreign exchange will be issued on demand. Meanwhile, the administered exchange regime will continue to be rationalized: semiannual reviews to estimate foreign exchange availability and demand will again be carried out in 1989; the average level of export retention rates will be reduced in light of the availability of resources for the aforementioned system of nonadministered allocation of foreign exchange; and a limited resale of "own exchange" imports will again be permitted. A two-stage reform of the customs tariff system will be completed by end-1989. The first stage, to be completed in early 1989, will focus on converting specific rates to an ad valorem basis and on rationalizing product categories and the number and ranges of rates. In the second stage, the structure of the tariff system will be simplified and the tariff nomenclature will be harmonized with international conventions.

b. Fiscal policies and public sector resource management

The improvement of the public sector financial performance and the strengthening of public sector resource management continue to be the core of fiscal policy in 1989 and in the medium term. Over the period 1989-91, gradual reductions are programmed for the current account and the overall deficits of the budget, in terms of GDP, which would entail the phasing out of the Government's recourse to domestic bank credit. Key policy measures are: increasing the buoyancy of the revenue structure; containing the growth of current expenditure; setting priorities for the public sector investment program; improving the coordination and utilization of external assistance; and enhancing the efficiency and profitability of the public enterprises.

The Government has introduced new revenue measures as well as further improvements in revenue administration and collection designed to increase significantly the buoyancy of the tax system. New revenue measures implemented in the 1989 budget include: (a) an increase in the turnover tax rate levied at the producer level from 5 percent to

10 percent; and (b) a reform of customs duties and administration through a rationalization and simplification of tariff rates, a strengthening of tax enforcement and operational procedures, and the elimination of import duty exemptions whenever possible. In addition, to rationalize certain taxes the business profits tax on dividends was eliminated and the rate of the proportional tax on dividends received by juridical persons was reduced from 50 percent to 18 percent. The overall impact of these tax measures is projected to be net incremental tax collections of Mt. 16.4 billion. The revenue base will also be reinforced by the transformation of most remaining specific consumption duties to an ad valorem basis. These changes will contribute to an increase in total revenue to GDP from 19.9 percent in 1988 to 22 percent in 1989. Import duties, which are projected to double again in 1989, would account for about 44 percent of the increase in tax revenue in the year. During the remainder of the program period, total revenue as a proportion of GDP will be increased by a further 2.5 percentage points, to 24.5 percent by 1991.

With regard to expenditure, fiscal policy will focus on containing its annual growth and establishing priorities within the overall expenditure growth, in line with the recommendations made by a public expenditure review (PER) conducted by Bank and Fund staff in 1987. In this regard, a census of civil servants and a review of civil service pay will be conducted in 1989, in order to rationalize the medium-term civil service salary and employment structure, while offering appropriate remuneration for higher skills and performance. Following the planned adjustment of administered prices and the elimination of certain food subsidies by end-March 1989, a general wage increase of 15 percent will be granted, together with a lump sum increase of Mt. 2,000 per worker. This package will increase the wage bill in the 1989 budget by 27 percent over that of 1988, and this will imply a modest decline in real terms. The fiscal program also contains a cap on budgetary subsidies at their 1988 level (Mt. 12 billion for enterprises and Mt. 3.5 billion for consumer subsidies), implying a further 30 percent reduction in real terms. The two combined subsidies will be reduced to the equivalent of 1.9 percent of GDP in 1989, from 8.8 percent in 1986 prior to the first annual program under the SAF. Restraint is also exercised in the 1989 budgetary outlays for goods and services. The relatively large increase in nominal outlays in 1989 is due primarily to the impact of exchange rate and other price adjustments; there is only a modest increase in real terms, which responds to the need to provide adequately for maintenance. Scheduled interest payments for 1989 are one third higher than in 1988, mainly reflecting the exchange rate adjustment and recent borrowing from the banking system (Table 3).

In accordance with recommendations of the PER, the development budget will give priority to most productive ongoing projects and to projects capable of quickly yielding or saving foreign exchange. Projects will be rigorously screened for economic justification, capacity for implementation, and maintenance. In this regard, before the end of 1989 an investment technical unit will be established within the

Ministry of Finance to assist in preparing and monitoring investment programs and financial plans. The development budget for 1989 foresees an increase in outlays of more than 60 percent (from 22 percent of GDP in 1988 to 26 percent in 1989), which implies a substantial increase in real terms after allowance is made for inflation and exchange rate adjustments.

As a result of these policies, the Government's financial position would be strengthened, yielding a reduction in the fiscal current account deficit equivalent to 1 percentage point of GDP in 1989, to be followed by a reduction of an additional 2 percentage points of GDP in the period 1990-91. In 1989, the overall deficit, after grants, is expected to decline to 10.2 percent of GDP from 14.2 percent of GDP in 1988; when the direct budgetary effects of the exchange rate adjustments (between January 1987 and December 1989) are excluded, the overall deficit declines to 6.7 percent of GDP in 1989, from 7.1 percent in 1988. As a result, government recourse to domestic bank credit will be reduced from Mt. 20 billion in 1988 (3.3 percent of GDP) to Mt. 15 billion in 1989 (1.8 percent of GDP) and will be reduced steadily thereafter with a view to its elimination by 1992; such financing was equivalent to 12 percent of GDP in 1986.

A central objective of the economic adjustment program is the restructuring of productive enterprises, 1/ including the strengthening of their financial position and the phased elimination of budgetary subsidies to loss-making enterprises. Some improvement in the financial operations of the enterprises has been achieved over the past two years through policy measures such as reducing price controls, allowing many enterprises to set their own prices with administered profit margins, and only ex post monitoring of price adjustments. Other measures include the granting of greater autonomy in decision making and the liberalization of marketing arrangements. In order to improve the performance of the productive enterprises further, however, the Government has started, with the assistance of World Bank consultants, a review of 40 agricultural and industrial enterprises and will prepare company-specific proposals for restructuring and rehabilitation. These enterprises have been required, inter alia, to provide details on their financial position to a technical unit established in late 1988 at the Ministry of Finance. The technical unit is currently assessing and will finalize restructuring plans for five enterprises. 2/ Action programs will be developed for a further ten enterprises in the course of 1989.

1/ These enterprises include public corporations as well as private corporations abandoned by their owners.

2/ The five enterprises are Cashew-de-Mozambique, Citrinos, Madeira (wood products), Metal Box Company, and CELMOQUE (producer of insulated wire and cables).

c. Monetary and credit policies

Over the period 1989-91, monetary and credit policies will aim at strengthening the external accounts and achieving the targeted reduction of the inflation rate, while permitting sufficient credit to support the rehabilitation and recovery process. Direct credit ceilings will remain the principal instrument of monetary control over the next few years; however, the authorities will take steps to develop other monetary policy instruments (e.g., a reserve requirement), to be used as necessary to meet the monetary objectives of the program. Within the overall credit ceilings, the Government's recourse to bank credit will be reduced in order to permit sufficient credit for the rest of the economy. The credit program for 1989 is based on an increase of about 30 percent in broad money, somewhat below the projected 33 percent increase in nominal GDP, and an improvement in net foreign assets of about US\$5 million. Domestic-sourced bank credit--net domestic credit minus the proceeds of concessional medium- and long-term external loans on-lent through the banking system--is targeted to increase by no more than Mt. 68 billion, equivalent to 29 percent of broad money stock at the beginning of the period; of that amount, net bank credit to the Government is limited to Mt. 15 billion. With the on-lending of external concessional loans through the banks projected at Mt. 22 billion, the overall expected availability of credit for the rest of the economy would increase by 32 percent, and would be sufficient to permit continued recovery of economic activity (Table 4).

To improve the efficiency of the allocation and the mobilization of domestic financial savings, the reforms of the structure of interest rates will be continued. A major simplification of the structure of lending rates was introduced on January 1, 1989; the number of pre-specified lending rates was reduced from 30 to 16, and priority categories I and II were combined. With regard to deposits, interest on term deposits will be paid on a prorated basis rather than at maturity. Under the program, the authorities are committed to achieving positive real interest rate levels by late 1989 or early 1990. Lending rates range from 22 to 30 percent, except for a category of preferential loans with lending rates of 14 to 22 percent. With the weighted average lending rate at about 20 percent and most term deposit rates at about 16-18 percent, most nominal rates adjusted for the expected rate of inflation of the year ahead would be positive in real terms by end-1989. In any event, a review of interest rates will be conducted at mid-1989 to ensure that the necessary adjustments are implemented so as to attain positive real interest rates as targeted.

d. Pricing and distribution policies

The focus of pricing and distribution policies will continue to be on further decontrol of items subject to price and distribution intervention. In this regard the number of commodities subject to fixed price controls, reduced from 44 in 1986 to 28 in 1988, was further reduced at the outset of 1989. Six agricultural products (groundnuts,

sunflower, mafurra, cashew nuts, copra, and cotton) were removed from the fixed price list, and guaranteed minimum producer prices will be established for them at the beginning of each agricultural season. In the case of the agricultural products processed domestically, reference prices will be determined in line with prevailing international prices. In addition, prices of dried and fresh fish, chicken, and manioc will be freely determined. The products remaining under fixed price controls--utility tariffs, products traded in markets dominated by monopolistic forces, and items considered strategic for security and social reasons--will be decontrolled as circumstances permit. Furthermore, the current policy of ex post monitoring of fixed-margin commodities will be continued. For both the products that remain under price control and those subject only to mark-up regulation, timely and frequent adjustment of prices will continue to be permitted to pass through increases in production costs fully to reflect market conditions and encourage efficient production.

In order to permit more flexibility to producers and traders, the Government will continue to liberalize distribution channels. In early 1989 the Government decontrolled the interregional trade of 15 final products, leaving only 15 essential products still subject to controls. The Government will also continue to permit enterprises to trade directly rather than through a wholesale intermediary.

3. Quantitative and structural benchmarks

The quantitative benchmarks established for the third-year SAF arrangement, and set forth in Table 2 of the letter from the Minister of Finance to the Managing Director dated February , 1989, are: quarterly ceilings on the expansion in net domestic credit of the banking system; ^{1/} quarterly ceilings on net bank credit to the Government; limitation on the contracting or guaranteeing of new nonconcessional external borrowing with a maturity of 1-12 years by the Government or the Bank of Mozambique; and targets for the improvement of the level of net international reserves, as well as gross international reserves (Table 5). Benchmarks for the implementation of structural policies are shown in Table 1 of the above-mentioned letter and relate to: (a) introduction of new tax measures and strengthening of tax administration to yield an increase of 2 percentage points in total revenue to GDP in 1989; (b) management of the exchange rate to ensure a modest real depreciation of the metical in 1989; (c) removal of additional products from the fixed price list in early 1989 and adjustment of administered prices to reflect underlying costs during the course of the year; (d) implementation of the agreed system of nonadministered allocation of foreign exchange for selected imported inputs by April 1989; and (e) implementation of the action program for the rehabilitation of five

^{1/} Defined to exclude credit to the nongovernment sector through on-lending of the counterpart of concessional medium- and long-term external loans channeled through the banking system.

enterprises for which requisite plans have been drawn up, and formulation of a specific action program for ten additional enterprises in 1989 (Table 6).

IV. External Financing Requirements in 1989 and the Medium-Term Balance of Payments Outlook

As anticipated in the original PFP and the SAF arrangement, only modest improvements in the external accounts of Mozambique are foreseen in 1989. Given the resource requirements for rehabilitation and the anticipated levels of external assistance, reflected in the size of the initial imbalances, prospects are for the external current account deficit (before grants) to continue to widen over the next several years even with relatively rapid export growth; however, the overall deficit is projected to be on a generally downward trend after 1989. Staff projections through 1993 indicate that Mozambique will require continuing exceptional financing throughout the program period and beyond. Debt service obligations (before debt relief) remain near US\$500 million per year, while the projected overall deficit declines from just under US\$440 million in 1989 to US\$380 million by 1993 (Table 7).

For 1989, the overall deficit of US\$438 million would represent a slight decline from the 1988 level. Reflecting rehabilitation needs and continuing recovery, imports are forecast to rise by 7 percent in volume terms, or by about 11 percent in U.S. dollar terms, to US\$850 million. Export earnings are expected to rise by more than 23 percent, mainly on the strength of volume growth in cashew nuts, to US\$120 million; however, this is still only about 40 percent of the peak export volume reached in 1980. The outlook for remittances of Mozambican miners in South Africa has improved as a result of a recent accord. Net service payments in 1989 are projected to rise, mainly owing to a sharp jump in interest due on refinancing.

The current account deficit is thus expected to increase in 1989 to about US\$958 million, of which US\$520 million (54 percent) would be covered by grants and a small net loan inflow. Accordingly, the overall external financing requirement, including a targeted small rise of US\$5 million in net international reserves (excluding accounts held as part of rescheduling agreements), is estimated at US\$443 million. Debt relief from Paris Club creditors is assumed in the program on terms similar to those provided in 1987; on this basis, the potential debt relief is estimated at US\$387 million. (Debt relief on more concessional terms, for example, Toronto terms on Paris Club debt, could yield additional debt relief. In addition, this potential debt relief assumes no rescheduling of interest, amounting to about US\$45 million per annum through 1993, which is as a result of the 1987-88 rescheduled debt.)

The third SAF loan would provide about US\$11 million. ^{1/} The remaining US\$45 million of financing is expected to come from an additional US\$20 million of resources pledged but not quantified at the Consultative Group Meeting in October 1988, and from an additional US\$30 million of debt relief on concessional terms granted by non-Paris Club creditors. This would complete the financing requirements for 1989.

In 1990 and beyond, export recovery is expected to continue at a rapid although decelerating pace, import growth to slow gradually, and the services deficit to decline as interest obligations begin to stabilize (Tables 7 and 8). Export growth is projected to exceed 15 percent in U.S. dollar terms between 1991 and 1993. Over the period, increases in unit volume are anticipated at approximately 4-5 percent a year; supplies of cashew nuts, which are quite responsive to producer price incentives, are expected to recover strongly, but little growth is expected from prawns, the other leading export. Import growth is projected to decelerate in value terms from over 10 percent in 1990 to an average of about 7 percent between 1991 and 1993, with average prices increasing by some 3-4 percent. Nevertheless, the trade deficit would continue to increase slowly.

Ordinary grant and loan receipts are assumed to grow by 6.5 percent annually in U.S. dollar terms between 1990 and 1993. In addition, Mozambique is one of the 14 countries eligible for participation in the World Bank's Special Program of Assistance (SPA) for low-income, heavily indebted African countries; therefore, the projections incorporate SPA inflows of about US\$80 million per annum in the period 1990-93. The projections also incorporate as a policy target an increase in reserves of about US\$15 million per year--to reach the equivalent of two months' imports by 1991--which could underpin the easing of trade and payment controls.

The projections show that the amounts and terms of debt relief will remain crucial to balance of payments manageability for Mozambique. For 1989, debt service obligations before debt relief are equivalent to 185 percent of expected current earnings; this ratio would be reduced only to 126 percent by 1993. After debt relief, actual debt service payments in 1989 are placed at 50 percent of earnings. With continued rescheduling on terms comparable with those assumed in 1988, the debt service ratio is likely to rise as the amount of "reschedulable" debt diminishes and interest on amounts already rescheduled grows.

^{1/} Equivalent to 13.5 percent of quota; any amount received under the third-year SAF arrangement in excess of this will be used to augment reserves.

V. Social Impact of the Program

The overall impact of the program has been to reverse the downward trend in average per capita consumption. Nevertheless, some measures in the adjustment program--including administered price increases, and particularly the reduction of food subsidies, as well as the rationalization of selected enterprises--are likely to have had an adverse short-term impact on some segments of the population, especially the lower-income urban dwellers. These transitional costs have been exacerbated by the repatriation of mine workers from South Africa and by the influx of displaced persons from the areas most affected by insecurity. The Government has taken steps, with the participation of United Nations (UN) agencies, to monitor the social impact of the program and other adverse pressures on the poor. In addition, the Government, in conjunction with the World Bank and other UN agencies, will formulate in 1989 a Food Security Strategy for Mozambique.

Besides efforts to strengthen food production and distribution and to facilitate general economic activity, the Government has also taken a number of measures to assist those sections of the population most affected by the transitional costs of adjustment and by the security situation. In order to ensure the availability of essential products, the authorities are continuing the rationing of some commodities and the distribution of free food under the emergency program. The Government is also expanding a pilot program that provides meals in primary schools and has started a similar program to improve meals in factories in Maputo. A household energy program was started to provide cheaper substitutes for wood fuel, thereby obviating the need for subsidies while also preserving the stocks of trees around the urban centers. Other programs under consideration to assist the poor include creating suburban "green areas" where the urban unemployed would have access to land and inputs for cultivation, initiating labor-intensive public works projects, and offering improved education and health services.

The efforts to ameliorate the short-term adverse impact of the adjustment on the most vulnerable elements of the population, however, are constrained by the difficulties of targeting such assistance. In this regard, the Government is assessing ways to provide targeted food subsidies to the poorest households, possibly by limiting supplies to specific residential zones and subsidizing only less preferred but nutritious foods. Such a process of targeting the provision of food and health services to the most vulnerable groups would help to limit their short-run budgetary impact and make it possible to phase them out only after the benefits of the recovery become sufficiently widespread.

VI. Staff Appraisal

The Mozambican authorities have been successfully pursuing a comprehensive economic recovery and rehabilitation program supported by a three-year SAF arrangement from the Fund approved on June 8, 1987. The

recovery program has been aimed at reversing the economy's long-term decline, reducing external and internal financial imbalances, and establishing the conditions for sustainable economic growth, once the internal security situation improves. The program, which has focused on improving the relative price structure in favor of production and investment, has been complemented by significant structural reforms in key economic sectors and supported by strengthened monetary and fiscal policies. The measures and reforms implemented under the first and second annual SAF arrangements have contributed measurably toward these objectives. Significant growth in real output has been achieved after years of decline, and major progress has been made in reducing domestic financial imbalances and in reducing the role of parallel markets. However, despite the considerable progress made in regularizing relations with trading partners and creditors, strengthening export incentives, and improving the international reserve position, the external accounts remain precarious and the need for sizable, exceptional balance of payments assistance will continue in the medium term.

The significant adjustments already made in the exchange rate and in other prices have greatly enhanced production incentives, particularly in the traded goods sector. In 1989, the authorities intend to continue the flexible management of the exchange rate through frequent but modest adjustments that would lead to some further real depreciation of the metical in the course of the year. The staff would underscore the importance of keeping exchange rate policy sufficiently flexible to permit the attainment of program objectives, which include a significant narrowing of the differential between the official and parallel market exchange rates and the successful implementation of the new system of nonadministered foreign exchange allocation for selected imports.

Significant progress also has been made in achieving realistic domestic prices and in reducing administrative interventions in the economy. In early 1989, further reductions were effected in the number of items subject to price controls and in the course of the year timely adjustments will be made in the remaining administered prices. The remaining consumer food subsidies will be largely eliminated on most basic staples by end-March 1989. At the same time, the system of minimum producer prices for key agricultural commodities is being broadened and further rationalized through explicit linking of domestic prices with cross-border prices. Adjustments in administered prices and the easing of administrative controls on trade already have contributed to improvements in the general availability of goods and helped to reduce significantly the role of parallel markets. The favorable supply response was reflected in the marked deceleration in the rate of inflation in 1988, a trend expected to continue in 1989. The decline in inflation will have broad-based economic benefits, some of which will accrue to the poorer elements of the population. The staff would also encourage the authorities to introduce and implement vigorously the measures envisaged for 1989 to reduce directly the adjustment burden on the economically disadvantaged elements of the population, in particular the urban dwellers most affected by the further reductions in food subsidies.

Fiscal policy aims at a reinforcement of public sector finances, an effort only partially illustrated in the programmed reductions in the current account and overall budget deficits (after grants) by 1 and 4 percentage points of GDP, respectively. The target of increasing revenue to 22 percent of GDP in 1989 translates into a considerable domestic effort; given the weight of subsistence production, tax receipts as a proportion of monetized GDP will amount to almost 30 percent. Given, however, that a significant part of the increase in revenue in 1989 is expected from improvements in the administration of import duties, the authorities should closely monitor revenue performance. In the event of a shortfall, additional revenue measures should be adopted to ensure the achievement of the program targets without undue retrenchment of priority expenditure. For the medium term, attainment of the planned increase in the revenue-to-GDP ratio would require measures to broaden the revenue base. A number of alternatives, including the extension of import duties to imports currently exempted, have been suggested by a staff technical assistance mission.

Public expenditures are driven by external debt service obligations and by large defense and rehabilitation requirements, and the growth of recurrent expenditures should continue to be restrained, particularly the growth of discretionary allocations such as wages, subsidies, and purchases of goods and services. The staff is encouraged by the authorities' ongoing efforts to strengthen the fiscal accounts, clearly reflected in the marked and sustained reduction in government access to bank credit, and the commitment to improve public resource management in general. As part of this process, the Government also is undertaking the reform of certain enterprises, which the staff views as a key component in strengthening public sector resource management. As further experience is required, the initial steps toward enterprise reform should be broadened and accorded high priority in future annual financial plans.

Monetary policy will continue to be aimed at restraining inflation and alleviating balance of payments pressures. The further reduction in borrowing by the Government from the banking system will moderate the expansion of total credit and liquidity, while permitting an appropriate credit flow to productive sectors. The structure of interest rates is being rationalized and the authorities expect that positive real interest rates will be achieved within a year. The authorities intend to review interest rates at the time of the 1989 Article IV consultation discussions to help ensure the achievement of positive interest rates by year-end. The staff welcomes the simplification of interest rates at the beginning of 1989 but notes that key deposit rates and the weighted average lending rate remain negative in real terms. There is a need to ensure that interest rates are properly aligned. The staff believes that the scope and scale of the subsidized bank lending rates should be progressively reduced on efficiency grounds; this would also increase the weighted average lending rates.

The prospects for a marked and sustained reduction in the resource gap in Mozambique, which is necessary for a significant turnaround in the balance of payments, remain severely hampered by the security situation. Besides the limitations on production and exports, foreign exchange receipts from the transshipment of goods have been greatly constrained. Despite the notable progress made during 1987-88, current earnings are little more than one third the level already achieved in 1984. Given the large import requirements for recovery and rehabilitation, even the strong export growth expected in the program period would not be sufficient to avoid an increase in the current account deficit. While in the absence of security-related disruptions and costs, Mozambique's policy course would be sufficient to lead to medium-term balance of payments viability, the present circumstances require sizable albeit declining exceptional financing well beyond the program period. Nonetheless, with full implementation of the economic program, a readiness to strengthen it as necessary, and continued strong support by the international community, Mozambique's external accounts should continue to be manageable.

The heavy debt service burden in combination with the reduced export base has yielded a debt service ratio after debt relief that approaches 60 percent, imposing a serious constraint on balance of payments management. The outlook for sustained growth with external viability would be considerably brightened if, within the context of the multiyear structural adjustment program, ways could be found to reduce substantially the debt burden. In this regard, the staff welcomes the authorities' progress in concluding bilateral agreements with Paris Club creditors. The staff would also encourage the authorities to pursue other avenues toward reduction of the debt burden, a process in which it would be prepared to assist.

The policies and measures set forth under the program supporting the Government's request for a third-year SAF arrangement represent a comprehensive effort to address the difficult economic problems facing Mozambique. The proposed program consolidates the broad-based gains already achieved and in key areas, such as rationalization of enterprises and foreign exchange allocation, introduces initial actions as part of bold reform programs; these programs will need to be augmented and sustained over time. In the staff's view the policies are appropriate to address the economic problems facing the country and sufficient to achieve program objectives. Accordingly, the staff recommends approval of Mozambique's request for the third annual arrangement under the structural adjustment facility.

VII. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

Third Annual Arrangement Under the SAF

1. The Government of Mozambique has requested the third annual arrangement under the structural adjustment facility.
2. The Fund has appraised the progress of Mozambique in implementing the policies and reaching the objectives of the program supported by the first and second annual arrangements, and notes the updated policy framework paper (EBD/89/58).
3. The Fund approves the arrangement set forth in EBS/89/27.

Table 1. Mozambique: Selected Economic and Financial Indicators, 1985-91

Economic and financial indicators	1985	1986	1987		1988		1989	1990	1991
			Prog. 1/	Actual	Prog.	Rev. est.	Prog.	Projections	
(Annual percentage changes, unless otherwise specified)									
Production and prices									
GDP at 1980 prices	-10.4	2.0	1.2	4.0	5.9	4.1	5.0	5.0	5.0
GDP deflator	51.0	15.6	...	145.5	63.1	38.7	26.4	14.3	9.5
Consumer prices	29.2	38.7	...	166.0	70.0	50.0	30.0	15.0	10.0
External trade (based on US\$ values)									
Exports, f.o.b.	-19.9	3.3	8.9	22.6	22.2	1.3	23.2	15.3	12.8
Imports, c.i.f.	-21.5	28.1	18.8	15.2	17.1	22.1	11.4	10.6	7.7
Terms of trade	5.0	14.2	-2.1	-0.8	-0.7	-6.6	1.2	2.7	1.0
Exchange rate									
Annual average (US\$/Mt.)	-1.7	6.8	-83.8	-86.1	-34.0	-45.0	...	...	...
Nominal effective 2/	7.3	-9.3	-90.8	-91.4	...	...	...	...	...
Government budget (cash basis)									
Revenue	-14.2	15.7	263.7	210.4	74.9	78.3	46.9	...	...
Tax revenue	-17.4	17.3	372.5	272.4	84.7	80.2	51.1	...	...
Total expenditure 3/	-11.6	30.3	256.7	207.4	103.0	84.0	48.6	...	...
Current expenditure 3/	17.3	28.9	149.4	113.7	71.1	73.6	38.3	...	...
Money and credit 4/									
Domestic credit (net)	16.1	17.1	23.7	28.8	35.7	39.1	29.8	...	...
Government (net)	21.4	21.7	76.0	43.8	42.3	42.3	22.3	...	...
Economy	14.9	16.1	11.0	25.2	31.7	38.2	32.0	...	...
Money and quasi-money	15.4	15.5	44.7	53.0	43.4	37.7	29.5	...	...
(As percent of GDP)									
Government budget									
Total revenue	13.1	13.3	19.9	16.1	16.1	19.9	22.0	23.0	24.0
Total expenditure	27.0	30.9	45.5	37.2	43.2	49.1	53.1	...	...
Current deficit	9.4	12.1	6.2	5.2	4.7	5.7	4.7	3.7	2.7
Overall deficit									
After grants	11.9	15.3	9.9	11.8	12.5	14.2	10.2	...	...
Domestic bank financing	9.4	12.0	6.2	3.9	2.7	3.3	1.8	1.0	0.5
(In units stated)									
Overall balance of payments deficit (US\$ millions)	353.4	488.0	458.7	448.0	491.5	470.1	437.6	473.3	417.3
Gross foreign reserves (months of imports, c.i.f.)	1.6	1.8	1.6	2.4	1.7 5/	1.9 5/	1.8	1.8	2.0
External debt (US\$ millions)	2,794	3,157	3,560	4,006	3,563	4,368	...	...	...
Of which: arrears	(589)	(711)	(--)	(--)	(--)	(--)	...	...	...
Debt service ratio 6/									
Before debt relief	215.4	247.4	236.6	232.4	240.6	233.2	185.1	181.4	154.1
After debt relief	110.4	247.4	45.1	25.8	57.6	54.4	...	...	...

Sources: Data provided by the Mozambican authorities; the World Bank; and staff estimates.

1/ Percent changes from data used for program, that is, revisions to 1986 data not reflected.

2/ December averages compared.

3/ Includes enterprise subsidies in expenditure data since 1987 (estimated bank credit for 1985-86).

4/ Does not include foreign borrowing on-lent through domestic credit, since 1987.

5/ Excludes the balances in the escrow account held at the Bank of France.

6/ External debt service as percent of exports of goods and services (including workers' remittances).

Table 2. Mozambique: Quantitative Benchmarks and Performance
Under the Structural Adjustment Facility, 1987 and 1988

	1987				1988			
	Mar.	June	Sept.	Dec.	Mar.	June	Sept.	Dec.
<u>(Cumulative changes in billions of meticals)</u>								
Domestic-sourced credit (net) <u>1/</u>								
Program	13.0	26.0	36.0	40.0	29.0	50.0	65.0	74.0
Actual	3.2	9.6	26.2	29.1	20.9	20.7	44.3	69.0
Net credit to Government								
Program	10.0	18.0	24.0	25.0	10.0	15.0	19.0	20.0
Actual	1.1	4.2	13.2	14.4	11.5	5.0	12.3	20.0
<u>(In millions of U.S. dollars)</u>								
Increase in gross international reserves								
Program	...	...	...	19.0	...	...	...	—
Actual	...	...	...	35.0	...	...	...	29.0 <u>2/</u>
Nonconcessional external borrowing of 1-12 year maturity that the Government or the Bank of Mozambique may contract or guarantee								
Program	...	...	...	20.0	...	...	...	20.0
Actual	...	...	...	14.0	...	...	...	--

Source: Bank of Mozambique.

1/ Excludes on-lending by domestic banks of external concessional loans of medium- and long-term maturity.

2/ Includes US\$48.0 million deposit with Bank of France to meet Paris Club obligations; excluding this account, net foreign assets declined by US\$8 million.

Table 3. Mozambique: Government Finances, 1985-89

	1985	1986	1987		1988		1989
			Prog.	Prel. actual	Prog.	Rev. est.	Prog.
(In billions of meticals)							
Total revenue	<u>19.1</u>	<u>22.1</u>	<u>80.5</u>	<u>68.6</u>	<u>120.0</u>	<u>122.3</u>	<u>179.6</u>
Tax revenue	<u>13.3</u>	<u>15.6</u>	<u>73.9</u>	<u>58.1</u>	<u>107.3</u>	<u>104.7</u>	<u>158.2</u>
Taxes on income and profits	<u>4.3</u>	<u>4.4</u>	<u>9.7</u>	<u>15.1</u>	<u>17.7</u>	<u>25.3</u>	<u>26.2</u>
Taxes on goods and services	<u>6.7</u>	<u>9.0</u>	<u>47.4</u>	<u>29.7</u>	<u>63.3</u>	<u>55.7</u>	<u>84.2</u>
Taxes on international trade	<u>1.5</u>	<u>1.5</u>	<u>13.2</u>	<u>9.9</u>	<u>21.5</u>	<u>18.9</u>	<u>42.5</u>
Other taxes	<u>0.8</u>	<u>0.7</u>	<u>3.6</u>	<u>3.4</u>	<u>4.8</u>	<u>4.8</u>	<u>5.3</u>
Nontax revenue	<u>5.8</u>	<u>6.5</u>	<u>6.6</u>	<u>10.5</u>	<u>12.7</u>	<u>17.6</u>	<u>21.4</u>
Current expenditure ^{1/}	<u>32.9</u>	<u>42.4</u>	<u>105.6</u>	<u>90.6</u>	<u>155.0</u>	<u>157.3</u>	<u>217.6</u>
Of which: budget year							
Defense and security	11.0	12.4	42.4	41.7	62.7	65.2	94.9
Salaries and wages	7.6	8.0	17.6	15.0	25.8	26.1	33.1
Goods and services	4.3	5.0	14.4	12.7	21.5	21.5	32.1
Interest on public debt ^{2/}	0.1	0.8	7.4	8.3	24.9	27.7	36.9
Food subsidies	0.5	0.5	6.8	5.8	3.0	3.0	3.0
Enterprise subsidies	9.0	14.2	14.0	9.0	12.5	12.5	12.5
Other current expenditures	0.9	1.3	5.5	2.0	8.1	5.9	9.6
Current deficit (surplus -)	13.8	20.2	25.1	22.0	35.0	35.0	38.0
Memo: Excluding interest	13.7	19.4	17.7	13.7	10.1	17.3	5.9
Capital expenditure ^{1/}	<u>6.7</u>	<u>9.3</u>	<u>78.5</u>	<u>68.0</u>	<u>167.0</u>	<u>134.5</u>	<u>216.0</u>
Total expenditure ^{1/}	<u>39.6</u>	<u>51.6</u>	<u>184.1</u>	<u>158.6</u>	<u>322.0</u>	<u>291.8</u>	<u>433.6</u>
Net lending (financial arrangement with railways corporation)	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>10.0</u>	<u>—</u>
Overall deficit before grants	20.4	29.5	103.6	90.0	202.0	179.5	254.0
Grants received	<u>3.0</u>	<u>3.9</u>	<u>63.6</u>	<u>39.6</u>	<u>108.5</u>	<u>91.8</u>	<u>170.8</u>
Overall deficit after grants	17.4	25.6	40.0	50.4	93.5	87.7	83.2
External borrowing (net)	<u>5.1</u>	<u>5.9</u>	<u>15.3</u>	<u>33.5</u>	<u>73.5</u>	<u>57.6</u>	<u>68.2</u>
Drawings	<u>5.2</u>	<u>6.1</u>	<u>24.4</u>	<u>36.0</u>	<u>86.5</u>	<u>62.7</u>	<u>85.8</u>
Amortizations (paid)	-0.1	-0.2	-9.1	-2.5	-13.0	-5.1	-17.5
Domestic financing (net)	<u>12.3</u>	<u>19.7</u>	<u>24.7</u>	<u>16.9</u>	<u>20.0</u>	<u>30.1</u>	<u>15.0</u>
Domestic bank financing (net)	<u>13.8</u>	<u>20.1</u>	<u>25.0</u>	<u>16.7</u>	<u>20.0</u>	<u>20.0</u>	<u>15.0</u>
Treasury bonds (nonbank sector)	—	—	—	—	—	9.6	—
Other financing and discrepancy	-1.5	-0.4	-0.3	0.2	—	0.5	—
(In percent)							
Ratios to GDP:							
Total revenue	13.1	13.3	19.9	16.1	16.1	19.9	22.0
Total expenditure	27.0	30.9	45.5	37.2	43.2	49.1	53.1
Current deficit	9.4	12.1	6.2	5.2	4.7	5.7	4.7
Overall deficit before grants	13.9	17.7	25.6	21.1	27.1	29.2	31.1
Overall deficit after grants	11.9	15.3	9.9	11.8	12.5	14.2	10.2
Domestic bank financing	9.4	12.0	6.2	3.9	2.7	3.3	1.8

Sources: Data provided by the Mozambican authorities; and staff estimates.

^{1/} Adjustments made to offset net effects of complementary period spending.

^{2/} Includes domestic debt service effective 1987.

Table 4. Mozambique: Monetary and Credit Developments, 1985-89

	1985	1986	1987		1988		1989
			Prog.	Actual	Prog.	Prel. est.	Prel.
<hr/>							
Balances, end of period	(In billions of meticals)						
Net foreign assets	0.6	0.4	9.7	23.0	37.4	25.0	37.1
Assets	2.9	3.5	39.9	61.1	...	...	...
Liabilities	-2.3	-3.1	-30.2	-38.1	...	...	...
Domestic credit (net)	144.2	168.9	208.9	217.5	295.1	302.5	392.7
Of which: domestic-sourced credit (net) 1/	(109.9)	(132.1)	(172.1)	(161.2)	(235.2)	(230.2)	(298.2)
Credit to Government (net)	27.0	32.9	57.9	47.3	67.3	67.3	82.3
Credit to the economy	117.1	136.0	151.0	170.2	224.2	235.2	310.4
Foreign funds on-lent 2/	(34.2)	(36.8)	(36.8)	(56.3)	(56.3)	(72.3)	(94.5)
Domestic-sourced credit	(82.9)	(99.2)	(114.2)	(113.9)	(167.9)	(162.9)	(215.9)
Money and quasi-money	96.5	111.4	161.2	170.4	244.4	234.6	303.8
Currency in circulation	29.8	32.2	...	36.6	...	51.7	...
Demand and savings deposits	62.8	75.1	...	124.0	...	174.0	...
Time deposits	3.9	4.1	...	9.8	...	8.9	...
Foreign borrowing	34.2	36.8	377.0	420.0	657.6	722.6	981.8
Valuation adjustments	—	—	-329.8	-382.4	-605.8	-631.9	-858.1
Other items (net)	14.0	21.1	10.3	32.5	32.5	2.2	2.2
Capital accounts	12.7	14.4	...	28.6	...	...	...
Other assets and liabilities	1.3	6.7	...	3.9	...	...	...
<hr/>							
Flows during year							
Net foreign assets	-0.4	-0.2	9.3	22.6	14.4	2.0	12.1
Domestic credit (net)	20.0	24.8	40.0	48.6	74.0	85.0	90.2
Of which: domestic-sourced credit (net) 1/	(13.0)	(22.2)	(40.0)	(29.1)	(74.0)	(69.0)	(68.0)
Credit to Government (net)	4.8	5.9	25.0	14.4	20.0	20.0	15.0
Credit to the economy	15.2	18.9	15.0	34.2	54.0	65.0	75.2
Foreign funds on-lent 2/	(7.0)	(2.6)	(--)	(19.5)	(--)	(16.0)	(22.2)
Domestic-sourced credit	(8.2)	(16.3)	(15.0)	(14.7)	(54.0)	(49.0)	(53.0)
Money and quasi-money	12.9	14.9	49.7	59.4	74.0	64.4	69.2
Foreign borrowing	7.0	2.6	340.2	383.2	237.6	302.6	259.2
Other items (net)	-0.3	7.1	-340.6	-371.0	-223.4	-279.3	-226.2
<hr/>							
Rates of change 2/	(In percent)						
Domestic credit (net)	16.1	17.1	23.7	28.8	35.7	39.1	29.8
Of which: domestic-sourced credit (net) 1/		20.2	30.3	22.0	45.9	42.8	29.5
Credit to Government (net)	21.4	21.7	76.0	43.8	42.3	42.3	22.3
Credit to the economy	14.9	16.1	11.0	25.2	31.7	38.2	32.0
Money and quasi-money	15.4	15.5	44.7	53.0	43.4	37.7	29.5

Sources: Bank of Mozambique; and staff estimates.

^{1/} Excludes foreign funds on-lent.

^{2/} Concessional external loans on-lent domestically through the banking system; excluded from program credit benchmarks.

Table 5. Mozambique: Quantitative Performance Benchmarks for the 1989 Program
Under the Structural Adjustment Facility

	Outstanding Dec. 1988 Est.	1989				Outstanding Dec. 1989
		Mar.	June	Sept.	Dec.	
(Cumulative changes in billions of meticaís)						
Net domestic bank credit <u>1/</u>	230.2	24.0	39.0	53.0	68.0	298.2
Net bank credit to Government	67.3	9.0	11.0	13.0	15.0	82.3
(In millions of U.S. dollars)						
Level of gross international reserves <u>2/</u>	37.3	--	--	--	5.0	42.3
External borrowing on nonconcessional terms that the Government or the Bank of Mozambique may contract or guarantee	...	--	--	--	20.0	--

Sources: Data provided by the Bank of Mozambique; and the letter of request.

1/ Changes indicated for domestic credit during 1989 exclude increases in credit to the economy on-lent from concessional external resources channelled through the banking system.

2/ End-December 1988 estimates and excludes US\$48.0 million deposits held with the Bank of France to meet Paris Club obligations.

Table 6. Mozambique: Benchmarks for Implementation of
Structural Policy Measures for the 1989 Program Under the
Structural Adjustment Facility

Policy measures	Time frame for measures
<u>Budgetary revenue measures</u>	
1. Implementation of agreed tax measures and strengthening of tax administration to yield an increase of 2 percentage points in the ratio of total revenue to GDP in 1989;	Begin with 1989
<u>External policies</u>	
2. Management of the exchange rate through frequent small adjustments to effect a moderate real depreciation of the metical in 1989;	Begin with 1989
3. Implementation of the agreed system of nonadministrative allocation of foreign exchange for key imported inputs for selected industries;	By April 1989
<u>Pricing policies</u>	
4. Relaxation of the administration of prices through removing additional products from the fixed price list, substituting minimum producer prices on selected agricultural commodities for for multilevel price controls, and effecting or permitting changes in administered prices to reflect exchange rate and other cost changes;	By end-March 1989
<u>Public sector management</u>	
5. Rehabilitation of selected enterprises already identified by the recently established technical unit in the Ministry of Finance, which in 1989 will formulate a specific action program for several additional enterprises.	By end-1989

Table 7. Mozambique: Balance of Payments, 1985-93

(In millions of U.S. dollars)

	1985	1986	Prog. 1987	Prel. 1987	Prog. 1988	Est. 1988	1989	1990	Project loans 1991	1992	1993
Trade balance	-347.1	-463.6	-564.0	-528.0	-647.0	-665.3	-728.9	-800.4	-854.6	-892.0	-954.7
Exports (f.o.b.)	76.6	79.1	86.0	97.0	105.0	98.3	121.1	139.6	157.4	177.9	201.0
Imports (c.i.f.)	-423.8	-542.7	-650.0	-625.0	-752.0	-763.6	-849.0	-940.0	-1,012.0	-1,070.0	-1,155.6
Services (net)	-92.9	-158.7	-141.0	-159.3	-249.0	-189.4	-229.1	-224.2	-212.0	-200.8	-191.5
Receipts	107.1	119.0	127.0	137.0	112.0	145.9	161.5	164.0	176.1	189.5	201.6
Transportation	39.4	45.0	58.0	35.1	41.0	40.0	44.0	50.6	58.2	66.9	73.6
Workers' remittances	40.8	50.0	43.0	58.0	30.0	65.0	73.5	67.6	70.3	73.1	76.0
Other service receipts	26.9	24.0	26.0	43.9	41.0	40.9	44.0	45.8	47.6	49.5	52.0
Expenditures	-200.0	-277.7	-268.0	-296.3	-361.0	-335.3	-390.6	-388.2	-388.1	-390.3	-393.1
Interest	-117.3	-154.7	-175.0	-159.7	-202.0	-204.8	-239.5	-236.2	-231.5	-229.9	-229.0
Scheduled	-74.3	-112.1	...	-125.1	...	-130.2	-143.3	-117.8	-91.4	-70.8	-52.6
On financing 1/	-40.2	-39.0	...	-30.8	...	-71.2	-84.2	-96.0	-106.0	-113.7	-117.0
On new borrowing	-2.9	-3.6	...	-3.8	...	-3.5	-12.0	-22.4	-34.1	-46.4	-59.5
Other transportation	-38.7	-34.0	-44.0	-33.9	-41.0	-42.7	-47.0	-48.9	-50.8	-52.9	-55.0
Workers' remittances	-25.0	-23.0	-25.0	-25.0	-27.0	-26.9	-29.6	-30.8	-32.0	-33.3	-34.6
Investment services 2/	...	-50.0	...	-54.7	-55.0	-27.6	-39.1	-35.5	-35.5	-33.4	-33.4
Other service expenditure	-19.0	-16.0	-24.0	-23.0	-36.0	-33.3	-35.4	-36.8	-38.3	-39.8	-41.4
Current account	-440.1	-622.3	-705.0	-687.3	-896.0	-854.7	-958.0	-1,024.6	-1,066.6	-1,092.8	-1,146.2
Unrequited official transfers	139.0	213.0	321.0	304.2	373.0	416.3	436.3	468.4	514.3	561.3	584.4
Of which: grants from anticipated new commit- ments 3/	(-)	(-)	(-)	(-)	(-)	(43.9)	(37.8)	(50.0)	(75.0)	(100.0)	(100.0)
Capital account	-39.7	-51.5	-19.0	-98.4	30.0	-99.9	84.1	82.9	135.0	149.2	180.8
Foreign borrowing	228.8	284.0	310.0	285.7	350.0	265.1	367.6	397.4	417.3	438.2	460.1
Amortization	-278.5	-335.5	-329.0	-384.1	-320.0	-365.0	-283.5	-314.5	-282.3	-289.0	-279.3
Scheduled	-278.5	-335.5	-329.0	-384.1	-320.0	-365.0	-283.5	-314.5	-282.3	-266.8	-234.2
On refinancing	...	...	...	...	...	...	...	...	...	-22.2	-45.1
Short-term capital (net)	10.0	...	...	...	...	...	...	...	...	...	...
Errors and omissions (net)	-12.7	-27.2	...	33.5	...	68.2	...	...	...	...	...
Overall balance	-353.4	-488.0	-404.0	-448.0	-491.5	-470.1	-437.6	-473.3	-417.3	-382.3	-381.0
Financing	353.4	488.0	404.0	448.0	491.5	470.1	437.6	473.3	417.3	382.3	381.0
Net foreign assets	7.7	5.8	-4.0	-35.5	24.5	33.2	5.9	-15.0	-20.0	-20.0	-13.1
Assets (increase -)	22.3	-19.0	-19.0	-50.9	...	9.6	-5.0	-15.0	-20.0	-20.0	-10.0
Reserve assets 4/	20.5	-23.5	-19.0	-64.9	...	9.6	-5.0	-15.0	-20.0	-20.0	-10.0
Bilateral payments agreements	2.3	4.9	...	7.9	...	...	...	...	...	...	...
Other	-0.4	-0.4	...	6.1	...	...	...	...	...	...	...
Liabilities	-14.6	24.8	15.0	15.4	24.5	23.6	10.9	...	...	...	-3.1
Of which: use of IMF credit (net)	(-)	(-)	(15.0)	(15.4)	(24.5)	(24.5)	(10.9)	(-)	...	...	-3.1
Net change in arrears (increase +)	152.7	482.2	...	-684.2	...	...	...	...	...	...	...
Additional financing	...	...	...	...	70.0	...	44.7	...	...	...	...
Exceptional financing/ Debt relief 5/	193.0	...	408.0	1,367.7	397.0	436.9	387.0	488.3	437.3	402.3	394.1
	193.0	...	408.0	1,367.7	397.0	436.9	...	...	...	...	...

Memorandum items:

Gross international reserves 4/	65.6	89.1	91.0	140.0	107.0	130.4	135.4	150.4	170.4	190.4	200.4
(in months of imports) 4/	1.6	1.8	1.6	2.4	1.7	1.9	1.8	1.8	2.0	2.1	2.0
Debt service rescheduling, Paris Club terms 6/	...	...	...	...	...	...	387.0	392.9	334.0	294.9	255.7
Debt service payments (actual)	50.1	8.0	96.0	60.3	125.0	136.0	...	...	...	...	...
Debt service ratio 7/	215.4	247.4	236.6	232.4	240.6	233.3	185.1	181.4	154.1	141.7	126.4
Before debt relief	110.4	247.4	45.1	25.8	57.6	54.4	...	...	...	...	...
After debt relief	...	...	...	...	...	...	...	...	...	...	...
Current earnings/payments (percent) 8/	36.3	29.8	28.7	30.7	23.8	27.3	28.2	27.8	28.5	29.9	30.5

Sources: Bank of Mozambique; and Fund staff estimates.

1/ Includes payments into the Bank of France escrow account.

2/ In 1987, does not reflect subsequent revision to include "investment services" payments (fees, profits, etc., financed from project loans).

3/ World Bank special initiatives for low-income, high-debt, sub-Saharan countries.

4/ Excludes the escrow account held in the Bank of France.

5/ Reflects Paris Club and similar agreements in principle, not ultimate bilateral agreements. Reflects (1) OPEC member agreements in 1985 on US\$96 million in arrears and US\$26.6 million in 1985 maturities, and Paris Club agreement on US\$70 million (for first half of 1985 maturities); (2) May 1987 London Club agreement on US\$268 million (mainly arrears); (3) June 1987 Paris Club agreement on US\$386 million (of arrears) for 1987, US\$159 million (of interest and principal) for 1988, and US\$140 million (of interests and principal) for 1989; and (4) other agreements on US\$713 million for 1987, US\$267 million for 1988, and US\$233 million for 1989.

6/ Includes 100 percent of reschedulable Paris Club, OPEC, and other country debt plus debt to centrally planned countries.

7/ As percentage of exports of goods and total services receipts.

8/ Ratio of current earnings from goods and services to current payments other than interest.

Table 8. Mozambique: Debt Service Projections on External Debt, 1986-95

(In millions of U.S. dollars)

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Original debt service	447.6	509.2	495.2	426.8	432.3	373.7	337.6	286.8	266.5	253.4
Principal	335.5	384.1	365.0	283.5	314.5	282.3	266.8	234.2	228.8	230.3
Multilateral	(3.5)	(6.2)	(9.5)	(8.6)	(11.1)	(10.9)	(14.9)	(8.0)	(8.0)	(8.0)
Bilateral	(332.0)	(377.9)	(355.5)	(274.9)	(303.4)	(271.4)	(251.9)	(226.2)	(220.8)	(222.3)
Of which:										
Paris Club	(...)	(81.8)	(98.1)	(90.3)	(122.9)	(131.2)	(128.9)	(105.0)	(105.0)	(104.5)
Other official	(...)	(283.7)	(239.3)	(179.2)	(178.7)	(138.2)	(121.2)	(119.7)	(114.3)	(117.2)
Banks	(...)	(12.4)	(18.1)	(5.4)	(1.8)	(2.0)	(1.8)	(1.5)	(1.5)	(0.6)
Interest	112.1	125.1	130.2	143.3	117.8	91.4	70.8	52.6	37.7	23.1
Multilateral	(2.8)	(4.3)	(7.3)	(7.2)	(6.7)	(5.9)	(5.1)	(3.2)	(3.1)	(2.9)
Bilateral	(109.3)	(120.8)	(122.9)	(136.1)	(111.1)	(85.5)	(65.7)	(49.4)	(34.6)	(20.2)
Of which:										
Paris Club	(...)	(74.3)	(77.6)	(70.5)	(78.2)	(55.0)	(43.3)	(33.6)	(25.3)	(16.9)
Other official	(...)	(45.6)	(42.9)	(64.4)	(32.2)	(30.0)	(22.1)	(15.4)	(9.2)	(3.2)
Banks	(...)	(0.9)	(2.4)	(1.2)	(0.7)	(0.5)	(0.3)	(0.4)	(0.1)	(0.1)
New debt service (on refinancing)	42.6	34.5	74.7	96.2	118.4	140.1	182.3	224.7	247.4	274.6
Principal	—	—	—	—	—	—	22.2	48.2	53.6	62.9
On refinancing	(—)	(—)	(—)	(—)	(—)	(—)	(22.2)	(45.1)	(45.6)	(52.7)
Of which: banks	(—)	(—)	(—)	(—)	(—)	(—)	(22.2)	(45.1)	(45.6)	(52.7)
On new borrowing	(—)	(—)	(—)	(—)	(—)	(—)	(—)	(—)	(—)	(—)
IMF repurchases	(—)	(—)	(—)	(—)	(—)	(—)	(—)	(3.1)	(8.0)	(10.2)
Interest	42.6	34.5	74.7	96.2	118.4	140.1	160.1	176.5	193.8	211.7
On refinancing ^{1/}	(39.0)	(30.8)	(71.2)	(84.2)	(96.0)	(106.0)	(113.7)	(117.0)	(119.9)	(122.2)
Of which: banks	(—)	(8.2)	(25.2)	(26.6)	(26.6)	(26.6)	(25.5)	(21.2)	(16.9)	(12.4)
On new borrowing	(3.6)	(3.7)	(3.4)	(11.8)	(22.1)	(33.8)	(46.2)	(59.3)	(73.7)	(89.3)
IMF charges	(...)	(0.1)	(0.1)	(0.2)	(0.3)	(0.3)	(0.3)	(0.2)	(0.2)	(0.2)
Total debt service	490.2	543.7	569.9	523.0	550.7	513.8	519.9	511.5	513.9	528.0
Principal	335.5	384.1	365.0	283.5	314.5	282.3	289.0	282.4	282.4	293.2
Interest	154.7	159.6	204.9	239.5	236.2	231.5	230.9	229.1	231.5	234.8

Source: Bank of Mozambique; and staff estimates.

^{1/} Includes imputed interest on arrears, as well as interest on exceptional financing (consolidated arrears, rescheduled current debt service maturities, and other).

Mozambique: Structural Adjustment Facility
Third Annual Arrangement

Attached hereto is a letter dated February 21, 1989 from the Minister of Finance of Mozambique, requesting from the Fund the third annual arrangement under the three-year structural adjustment arrangement for Mozambique, and setting forth the objectives and policies of the program to be supported by the third annual arrangement.

To support these objectives and policies, the Fund grants the requested arrangement in accordance with the following provisions and subject to the Regulations for Administration of the Structural Adjustment Facility:

1. The third loan in the amount equivalent to SDR 8.235 million is available for disbursement at the request of Mozambique.

2. The Fund will appraise the progress of Mozambique in implementing the policies and reaching the objectives of the program supported by the third annual arrangement, taking into account primarily:

a. the indicators specified in Tables 1 and 2 attached to the letter dated February 21, 1989.

b. imposition or intensification of restrictions on payments and transfers for current international transactions;

c. introduction of multiple currency practices.

d. conclusion of bilateral payments agreements that are inconsistent with Article VIII; and

e. imposition or intensification of import restrictions for balance of payments reasons.

3. In accordance with paragraph 19 of the attached letter, dated February , 1989, Mozambique will provide the Fund with such information as the Fund requests in connection with the progress of Mozambique in implementing the policies and reaching the objectives supported by the third annual arrangement.

4. In accordance with paragraph 19 of the attached letter, Mozambique will consult with the Managing Director on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because of deviation from any of the indicators under paragraph 2 above or because he considers that consultation on the program is desirable. These consultations may include correspondence and visits of officials of the Fund to Mozambique or of representatives of Mozambique to the Fund.

February 21, 1989

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Camdessus:

1. On June 8, 1987, the Fund Executive Board approved a three-year arrangement and the first annual arrangement under the Structural Adjustment Facility (SAF) in support of our Economic Recovery Program (ERP) as outlined in a policy framework paper (PFP) for 1987-89 and a program for 1987. On March 8, 1988 the Fund Executive Board approved a second annual arrangement under the SAF. The three-year SAF arrangement provided assistance that amounts to SDR 38.74 million, equivalent to 63.5 percent of Mozambique's quota, and first and second annual loans under the arrangement equivalent to SDR 12.2 million, or 20 percent of quota, and to SDR 18.3 million, or 30 percent of quota, respectively. The ERP is aimed at reversing the long-term economic decline and correcting the large internal and external financial imbalances.
2. The economic programs for the first- and second-year arrangements under the SAF were implemented largely as envisaged; the economic decline that characterized the past several years was reversed; and there was renewed economic growth in 1987-88. The financial targets for the 1987 and 1988 programs relating to the budget, domestic bank credit, and external borrowing were largely attained, and quarterly benchmarks on total domestic credit expansion and net bank credit to the Government were also observed.
3. In collaboration with Fund and World Bank staff, we have updated the policy framework paper to cover the period 1989-91. The updated PFP has been transmitted to you and the President of the World Bank. The broad objectives and strategy of the policy framework paper remain basically the same as under the original PFP and are detailed in the updated version, with a summary in the policy matrix. In the following paragraphs, this letter sets out certain more specific aspects of objectives and policies underlying the program for 1989. In support of this program, the Government of the People's Republic of Mozambique requests a third annual arrangement under the SAF in an amount equivalent to SDR 8.2 million (or 13.5 percent of quota).
4. During the three-year period January 1, 1989-December 31, 1991, the Government of Mozambique will continue to implement economic and financial policies aimed at promoting growth and adjustment. These policies, are a continuation of reform measures initiated with the Economic Rehabilitation Program (ERP) supported by the first and second annual arrangements under the SAF. Economic and structural difficulties facing

Mozambique, together with the main goals of the three-year (1989-91) program and key policies adopted to achieve them are described in the policy framework paper (PFP). The following paragraphs of the present letter describe in detail the macroeconomic and structural adjustment policies that will be implemented in the third year of the ERP, for which Fund support under the third year of the SAF is requested, together with quantitative and structural benchmarks that will facilitate the monitoring of progress in the key areas under the arrangement.

5. The program's objectives consistent with those of the original ERP, are to: (i) continue the recovery from the earlier decline in production and restore a minimum level of consumption and income for all the population, including in particular the rural areas; (ii) substantially reduce the domestic financial imbalances and strengthen the external accounts and reserves; (iii) enhance efficiency and establish the conditions for a return to higher levels of economic growth once the security situation and other exogenous constraints have eased; (iv) reintegrate official and parallel markets; and (v) restore and maintain orderly financial relationships with trading partners and creditors. In 1989 the program will also aim at (1) achieving a rate of growth of real GDP of at least 5 percent, which will allow for a somewhat greater increase in real GDP per capita than in the first two years of the ERP; (2) reducing the rate of increase in the average price level from an estimated 50 percent in 1988 to 30 percent in 1989; and (3) strengthening the balance of payments position through a further recovery of the export base, improving the external debt profile and, in cooperation with creditors, reducing the burden of external debt service.

6. In order to achieve the overall objectives of the program, the policy direction and structural reform efforts outlined in the program, supported by the first and the second annual arrangements under the SAF, will be continued, modified, and supplemented as necessary. In particular, economic policies will focus on providing the economy with appropriate price signals mainly through continued flexibility in the management of the exchange rate and relaxation of price controls; improving the resource mobilization and savings potential of the public sector through a substantial strengthening of the Government's revenue base and containment of recurrent expenditure; reducing the overall budget deficit (after grants) in terms of GDP; implementing a monetary policy consistent with the targets for the balance of payments and the rate of inflation, and the reduction of the Government's reliance on bank borrowing; improving financial intermediation through achieving positive real interest rates by end-1989/early 1991, and by setting the extension of credit on a sound commercial basis; and strengthening the public sector's resource management.

7. During 1989, the Government intends to continue to implement its flexible exchange rate policy through more frequent smaller adjustments of the nominal official exchange rate, with a view to achieving a moderate real depreciation during the year. The path of the adjustment will be reviewed quarterly in light of actual price developments in

Mozambique and abroad to ensure that the adjustment path remains consistent with a real depreciation of the exchange rate. Furthermore, the Government will review with the Fund staff the implementation of exchange rate policy in July 1989, at the time of the discussions for the next Article IV consultation, to ensure that the pace of real depreciation has been consistent with a narrowing of the gap between the official and the parallel market exchange rates; successful implementation of the new scheme of nonadministrative foreign exchange allocation for specified imports; and, attainment of the targeted improvement in the level of net official international reserves. Taking into account the findings of this joint review, the Government will modify the pace of adjustment of the exchange rate if and as necessary to achieve the program's objectives. As in the previous years, there will be a full pass-through of exchange rate charges to fixed prices and "conditioned" commodities.

8. Consistent with the objective of reducing reliance on administrative controls, and having already achieved a substantial realignment of the exchange rate through end-1988, effective April 1989, the Government will issue import licenses and foreign exchange on demand for a limited number of commodity imports, initially consisting of raw materials and spare parts. The scheme of nonadministrative allocation of foreign exchange, which will initially be supported by the World Bank's third rehabilitation credit, will begin with a small number of imports for specific sectors, with the ranges to be extended as balance of payments conditions permit. In order to provide a firm basis for the nonadministrative allocation of the foreign exchange system, the Government will introduce in 1989 a new foreign exchange law that, inter alia, will more clearly define and broaden the list of transactions that would take place in the official market so as to narrow the scope of the parallel market. Also consistent with the introduction of this import scheme and with the program's exchange rate policy, a substantial reform of the tariff structure will be undertaken in 1989. Tariff legislation will be simplified and specific rates will be converted to an ad valorem basis; the reform will focus on the simplification of the rate structure through a consolidation of product category and a reduction on the number of ranges, while maintaining revenue from this source.

9. In early 1989 the Government will conclude all outstanding bilateral agreements in principle with the Paris Club creditors and during 1989 will continue in its attempts to finalize the agreement in principle with the private and commercial creditors. In light of Mozambique's acute external debt and debt service situation, the Government intends to explore all potential avenues to reduce the debt burden. In this regard, the Government will seek further comprehensive debt relief from all official creditors on concessional terms; through modalities such as the conversion of credits into grants, and the introduction of concessional interest rates on nonconcessional loans. Furthermore, with the assistance of the World Bank and the Fund, the Government will explore possible schemes for reducing its debt burden with commercial and private creditors in order to enhance the prospects of early attainment

of medium-term balance of payments viability. Other than possible re-financing loans under pending debt rescheduling arrangements, the Government and the Bank of Mozambique will not contract or guarantee external loans on nonconcessional terms of 1-12 years' maturity in excess of US\$50 million, during 1989-91, of which not more than US\$20 million will be contracted in 1989. The Government will refrain from accumulating new external payments arrears, excluding arrears arising from debt service payments pending conclusion of the rescheduling agreement. No new bilateral payments agreements will be concluded with Fund members.

10. The Government has introduced with the 1989 budget new tax measures and improvements in revenue administration and collection designed to yield about Mt. 17 billion, which would increase the projected revenue during the year to 22 percent of GDP, from 19.9 percent in 1988. These measures are: (1) the elimination of the business profits tax on dividends; (2) a reduction of the rate of the proportional tax on dividends received by juridical persons from 50 percent to 18 percent; (3) reduction of the applicability of the complementary tax on individual income; (4) an increase in the turnover tax rate levied at the producer level from 5 percent to 10 percent; (5) a reform of customs duties and administration through: (i) a rationalization and simplification of tariff rates; (ii) a strengthening of management and operational procedures, including tax enforcement; and (iii) the elimination of most exemptions on dutiable imports. To support the revenue effort and facilitate the attainment of the overall fiscal goals, expenditure policies incorporated in the 1989 budget are geared toward enhancing policy implementation and constraining overall outlays. The civil service wage bill is expected to increase from the 1988 level by no more than the anticipated average inflation rate. The average wage awards for 1989 will consist of an increase of about 15 percent in March/April 1989, which should approximately compensate for price increases during the period October 1988-March 1989. Much of the increase in consumer prices projected for 1989 would take place in the February-March period, reflecting the planned elimination of certain subsidies. Therefore, in addition to this general wage increase, a fixed increase of Mt. 2,000 per worker will be granted. This package will result in a modest real increase in the minimum wage. In 1989, budgetary subsidies to loss-making enterprises will not exceed Mt. 12 billion, and consumer subsidies will be kept at a level of Mt. 3.5 billion, implying a 30 percent real reduction in each category. To maintain sound financial management, all domestic interest will be paid by the Government when due. In the case of external debt, interest charges payable after rescheduling are being paid to the Bank of Mozambique according to the agreed schedule.

11. With the above revenue measures and restraint in recurrent expenditure, it is foreseen that the budget's current account deficit will be reduced to 4.7 percent of GDP in 1989, from 5.7 percent in 1988. The overall budgetary deficit, after grants, which for 1988 is estimated at 14.2 percent of GDP, also will be reduced to 10.2 percent of GDP in

1989. Moreover, the Government's recourse to domestic bank credit in 1989 will be reduced to Mt. 15 billion. The ratio of bank financing to GDP will decline by 1.4 percentage points to a level of 1.7 percent, from over 12 percent in the year prior to introduction of the ERP. If any significant adverse deviations from the foregoing targets take place, the Government will take offsetting measures to ensure that the program's fiscal targets for 1989 are attained.

12. A major requirement in improving public sector management is the strengthening of the institutional capability of the Government to enhance policy implementation. In 1989, all new major projects will be evaluated and subject to the scrutiny of the Cabinet. In addition, the Planning Commission (CNP) will initiate in 1989 the preparation of a three-year investment program of core projects, and will establish a data base for ongoing projects to improve its monitoring and control capability. The Ministry of Finance and CNP will also design a rolling medium-term financial plan for the Government, which will establish priorities between expenditures on operation, maintenance, and rehabilitation on the one hand, and new capital investment on the other hand. To assist in the preparation and monitoring of both the investment program and the financial plan, an Investment Technical Unit within the Ministry of Finance will also be created by the end of 1988, and the planning and budgeting departments of sectoral ministries will be strengthened.

13. The program's objectives with regard to monetary and credit policies are to conform the rate of money growth to the inflation and balance of payments targets, while providing an adequate supply of credit to the productive sectors. This objective will be achieved primarily through limiting the expansion in net bank credit to Government and by improving the process of credit supply and containment of domestic liquidity. For 1989, broad money is projected to expand by 30 percent, or somewhat less than the projected 33 percent increase in nominal GDP. Taking into account the targeted improvement in net international reserves of US\$5 million, the expansion in net domestic-sourced credit of the banking system [excluding credit to the economy arising from on-lending of external concessional loans through the banking system] will be limited to Mt. 68 billion, or 29 percent of the beginning period estimated money stock; of this amount, no more than Mt. 15 billion will be made available as net financing for the Government. Quarterly benchmarks have been established on net domestic credit expansion and net bank credit to the Government. Accordingly the increase, in 1989, in net domestic credit (excluding concessional loans on-lent through the banks) will be limited to Mt. 24 billion through end-March, Mt. 39 billion through end-June, Mt. 53 billion through end-September, and Mt. 68 billion through end-December 1989. Net credit to Government by the banking system will be limited to Mt. 9 billion through end-March, Mt. 11 billion through end-June, Mt. 13 billion through end-September, and Mt. 15 billion through end-December 1989.

14. To improve financial intermediation and the allocation of domestic financial savings, the Government will continue the reform in the structure of interest rates. A major simplification of the structure of bank lending rates was introduced in January 1989. With respect to deposits, provision has been made for regular payment of interest on term deposits rather than at deposit maturity, which should enhance their attractiveness as a savings instrument. The Government believes that with the rapid deceleration of inflation already achieved in Mozambique with the financial program for 1989, the present level of interest rates will become positive in real terms by late 1989/early 1990. In particular, the weighted average lending rates and most term deposit rates should be positive after the nominal rates are adjusted for the expected rate of inflation for the year ahead. Progress toward this objective will be monitored closely in 1989, and reviewed with the Fund staff at the time of the next consultation discussions, to determine whether further adjustments in nominal rates would prove necessary. To improve the efficiency of the banking system, the planned introduction of a new accounting system and the separation of the central banking and commercial functions of the Bank of Mozambique will be finalized before the end of 1990. In addition, the soundness of the financial system will be enhanced through a continuation of the review of nonperforming loans, which was initiated in 1988, and the establishment of special reserves to take into account such loans.

15. The number of commodities subject to price control was reduced from 44 in 1986 to 28 in 1988. The remaining commodities will be reviewed with the aim of gradually reducing their number except for: those that are considered essential consumer items, largely supplied through external assistance; commodities considered strategic in light of the security structure; products traded in markets dominated by state or other monopolies. At the outset of 1989, 8 additional commodities were removed from the fixed price list; for six of these products minimum producer prices have been established. Regarding the products that remain under control and for those subject to markup regulation, prices will be adjusted to pass through fully to users, increases in production costs as well as to reflect market conditions, and to encourage efficient production. Along with the decontrol of prices of consumer items, the Government will continue to liberalize regional trade with the decontrolling of a further 15 final products by early 1989, while enterprises will continue to be permitted to trade directly with other enterprises, rather than through a wholesale intermediary.

16. Structural policies for 1989 are spelled out in detail in the updated PFP, and from among them, those for monitoring structural policy implementation are shown as benchmarks in Table 1 and relate to:

(i) Implementation of agreed tax measures and strengthening of tax administration to yield an increase of 2 percentage points in the ratio of total revenue to GDP in 1989;

(ii) Management of the exchange rate through frequent small adjustments to effect a moderate real depreciation in 1989;

(iii) Relaxing the administration of prices through removing additional products from the fixed price list, substitution of minimum producer prices on selected agricultural commodities for multi-level price controls, and effecting or permitting changes in administered prices to reflect exchange rate and after-cost changes;

(iv) Implementing the agreed system of nonadministrative allocation of foreign exchange for key imported inputs for selected industries;

(v) Rehabilitation of selected enterprises already identified by the recently established technical unit in the Ministry of Finance, which in 1989 will formulate a specific action program for several additional enterprises.

17. The quantitative benchmarks for 1989 set forth in Table 2 comprise quarterly limits on (i) aggregate bank credit and (ii) net bank credit to Government, and annual limits on (iii) new external loans on nonconcessional terms contracted or guaranteed by the Government and the Bank of Mozambique in the maturity range of 1-12 years. Targets have been set for an increase in net international reserves as well as gross international reserves, of at least US\$5 million, excluding any changes in the escrow account with the Bank of France as per the arrangement with the Paris Club creditors.

18. During the program period, the Government does not intend to: (a) modify existing or introduce multiple currency practices; (b) impose new or intensify existing restrictions on payments and transfers for current international transactions, or, for balance of payments reasons, introduce any new or intensify existing restrictions on imports; (c) conclude any new bilateral payments agreements with member countries of the Fund. The Government will refrain from accumulating external payments arrears, excluding debt service payments subject to rescheduling.

19. The Government of the People's Republic of Mozambique believes that the policies and measures described in this letter and in its updated PFP are appropriate to attain the objectives of its program for 1989, but it will take any further measures that may become necessary for this purpose. The Government will consult with the Managing Director of the Fund on the adoption of any measure that may become appropriate, either on its own initiative or if the Managing Director requests such consultations. In addition, the Government will remain in close contact with the staff of the Fund and the World Bank on developments and progress in implementing these policies. The Government will provide the Fund with

such information as the Fund requests in connection with its progress in implementing the policies and achieving the objectives of the program. The Government of the People's Republic of Mozambique remains convinced of the need to sustain its medium-term adjustment efforts, and, in this endeavor, counts on the continued assistance of the Fund.

Sincerely,
/s/
Abdul Magid Osman
Minister of Finance

Table 1. Mozambique: Benchmarks for Implementation of Structural Policy Measures for the 1989 Program under the Structural Adjustment Facility

Policy measures	Time frame for measures
<u>Budgetary revenue measures</u>	
1. Implementation of agreed tax measures and strengthening of tax administration to yield an increase of 2 percentage points in the ratio of total revenue to GDP in 1989;	Begin with 1989
<u>External policies</u>	
2. Management of the exchange rate through frequent small adjustments to effect a moderate real depreciation in 1989;	Begin with 1989
3. Implementing the agreed system of non-administrative allocation of foreign exchange for key imported inputs for selected industries;	By April, 1989
<u>Pricing policies</u>	
4. Relaxing the administration of prices through removing additional products from the fixed price list, substitution of minimum producer prices on selected agricultural commodities for multi-level price controls, and effecting or permitting changes in administered prices to reflect exchange rate and other cost changes;	By end-March 1989
<u>Public sector management</u>	
5. Rehabilitation of selected enterprises already identified by the recently established technical unit in the Ministry of Finance, which in 1989 will formulate a specific action program for several additional enterprises.	By end-1989

Table 2. Mozambique: Quantitative Performance Benchmarks for 1989

	Outstanding Dec. 1988 Est.	1989				Outstanding Dec. 1989
		Mar.	June	Sept.	Dec.	
(Cumulative changes in billions of meticaïs)						
1. Net domestic bank credit <u>1/</u>	230.2	24.0	39.0	53.0	68.0	298.2
2. Net bank credit to Government	67.3	9.0	11.0	13.0	15.0	82.3
(In millions of U.S. dollars)						
3. Level of net international reserves	37.3 <u>2/</u>	--	--	--	5.0	42.3
4. External borrowing of nonconcessional term of 1-12 years' maturity the Government or the Bank of Mozambique may contract or guarantee		--	--	--	20.0	--

Sources: Data provided by the Bank of Mozambique; and 1989 program benchmarks.

1/ Changes indicated for domestic credit during 1989 exclude increases in credit to the economy through on-lending of concessional medium- and long-term external loans channeled through the banking system.

2/ Excludes US\$48.0 million deposits held with the Bank of France to meet Paris Club obligations.

MOZAMBIQUE - Relations with the Fund
(As of January 31, 1989)

I. Membership Status

- (a) Date of membership: September 24, 1984
(b) Status: Article XIV

A. Financial Relations

II. General Department

- (a) Quota: SDR 61.0 million
(b) Total Fund holdings of meticaïs: SDR 61.0 million
(100.0 percent of quota)
(c) Fund credit (SAF): SDR 30.5 million
(50.0 percent of quota)
(d) Reserve tranche position: -- 1/

III. Current Arrangements and Special Facilities

Arrangements under structural adjustment facility (1987-89)
Approved on June 8, 1987 for a total of SDR 28.67 million
(47 percent of quota)
First-year loan disbursed on June 11, 1987, of SDR 12.20
million (20 percent of quota)
Total raised per first review of facility to SDR 38.735
million (63.5 percent of quota)
Second-year loan disbursement on April 5, 1988 of SDR 18.3
million (30 percent of quota)

IV. SDR Department

- (a) Net cumulative allocation: None
(b) Holdings: SDR 20,374

V. Administered Accounts: None

VI. Overdue Obligations to the Fund: None

B. Nonfinancial Relations

- VII. Exchange Rate Arrangement: Since January 31, 1987, Mozambique's currency, the metical (plural: meticaïs) has been pegged to the U.S. dollar, the former peg to a weighted basket of six currencies having been suspended on that date. On January 1, 1989, the exchange rate for the metical was devalued to Mt. 645 per U.S. dollar. Rates based on market quotations for 20 other currencies are published daily.

1/ SDR 7,184.

MOZAMBIQUE - Relations with the Fund (continued)

- VIII. Consultation with the Fund: The last Article IV consultation discussions were held in Maputo during August 13-24, 1988.

Executive Board discussion of the staff reports (SM/88/227 and SM/88/246) took place on November 23, 1988, and the following decision was adopted:

1. The Fund takes this decision relating to the exchange measures of the People's Republic of Mozambique subject to Article VIII, Section 2(a), and in concluding the 1988 Article XIV consultation with the People's Republic of Mozambique, in the light of the 1988 Article IV consultation with the People's Republic of Mozambique conducted under Decision No. 5392-(77/63), adopted April 29, 1977 as amended (Surveillance over Exchange Rate Policies).

2. As described in SM/88/246, the People's Republic of Mozambique continues to maintain restrictions on payments and transfers for current international transactions in accordance with Article XIV, Section 2, except that the exchange restrictions evidenced by external payments arrears, the restrictions remaining pending the execution of the rescheduling agreement with each individual creditor and the restrictive features of bilateral payments agreements between Mozambique and other Fund members are subject to approval under Article VIII, Section 2(a). The Fund notes the intention of Mozambique to eliminate the exchange restrictions evidenced by external payments arrears and urges the authorities to eliminate the restrictive features of the bilateral payments agreements that the People's Republic of Mozambique maintains with Fund members. In the meantime, the Fund grants approval for the retention by Mozambique of the exchange restrictions evidenced by external payments arrears and those remaining pending the execution of the rescheduling agreements with each individual creditor until December 31, 1989, or until the conclusion of the next Article IV consultation with Mozambique, whichever is earlier.

It was expected that consultations with Mozambique would take place on the standard 12-month cycle.

- IX. SAF Arrangements: The Executive Board took the following decision on March 30, 1988:

1. The Government of Mozambique has requested the second annual arrangement under the Structural Adjustment Facility.

MOZAMBIQUE - Relations with the Fund (concluded)

2. The Fund has appraised the progress of Mozambique in implementing the policies and reaching the objectives of the program supported by the first annual arrangement, and notes the updated policy framework paper (EBD/88/68).
3. The Fund approves the arrangements set forth in EBS/88/40.

X. Technical Assistance

1. Statistics. An initial Bureau of Statistics mission in August 1985 assessed Mozambique's needs for technical assistance in statistics. Technical assistance on compiling monetary statistics and developing more suitable accounts was provided to the Bank of Mozambique in early November 1985; a joint Bureau of Statistics and Bureau of Computing Services mission in April-May 1986 followed up on these matters. Work on preparation of an IFS country page took place during the August 1987 consultation mission. A technical assistance mission on the balance of payments also took place in August 1987.
2. CBD Advisors. Following a Central Banking Department staff visit in August 1985 to assess needs for banking advisors, a Macroeconomic Advisor from the panel of experts was provided to the Bank of Mozambique in February 1986; his initial term has been renewed for a second, third, and fourth year. Since May 1986 an Accounting Advisor has been assigned to help revise the banking system's accounts; his initial term has also been extended for a second year. An Advisor in Organization and Methods has been provided to the Bank of Mozambique for an initial one-year term beginning in November 1987.
3. Fiscal Affairs. A Fiscal Affairs Department technical assistance mission visited Maputo for three weeks in October-November 1987 to review the country's customs and domestic tax systems and their administration. Since June 1988, an advisor under the Fiscal Panel of Experts has been assigned to Maputo to assist with the implementation of recommendations of the technical assistance mission.
4. IMF Institute. A two-week seminar on techniques of economic analysis was conducted in Maputo for senior Mozambican officials from June 23 to July 4, 1986 under the direction of the IMF Institute, with participation by the Bureau of Statistics and the African Department.

MOZAMBIQUE - Relations with the World Bank

The first World Bank economic mission to Mozambique took place in November 1984. IDA approved a first Rehabilitation Credit of SDR 45.5 million equivalent on June 18, 1985, to help meet Mozambique's priority needs in the industrial, transport, and agricultural sectors. The Norwegian and Italian Governments have committed an additional US\$22 million in cofinancing with the credit. On May 29, 1986, IFC provided about US\$2.5 million in financing for the LOMACO company, a major commercial agricultural producer, and on July 28, 1987, IFC took an equity position of up to US\$7.75 million in an oil exploration program offshore from Xai-xai with British Petroleum. On May 26, 1987, the Executive Board approved an IDA credit of SDR 15.6 million for a project in the energy sector (based on the conclusions of a recently issued Energy Assessment Report for Mozambique) which incorporates reforms in energy pricing, investment planning, and financial management for the electricity and petroleum subsectors. A second IDA Rehabilitation Credit of SDR 54.5 million, together with SDR 14.5 million from the Special Fund for Africa, was approved by the Bank's Executive Board on August 4, 1987; and a Swiss Special Joint Financing grant (Bank-administered) of Sw F 16.9 million and a Swiss cofinancing grant of Sw F 10.0 million were associated with these credits. In 1988, the Executive Board approved two IDA credits: SDR 11.7 million for education (May 1988) and SDR 44.0 million for urban rehabilitation (August 1988).

Bank assistance to Mozambique is being focused primarily on rehabilitation of the economy, in the context of the Government's comprehensive program of economic reforms. An IDA third rehabilitation credit to support the introduction of a limited Open General License scheme is currently under discussion with the authorities. An IDA credit for about SDR 10 million is also being appraised to provide complementary technical assistance in economic and financial management to assist the Government in identifying and carrying out future policy adjustments. At the sector level, an education project focusing on primary schooling is under appraisal, with a view to an IDA credit of about SDR 10 million. Future lending operations are also expected for the education, transport, health, industry, and urban sectors.

The agenda for economic and sector work is designed primarily to support the efforts of the Government to adopt more appropriate economic policies. A Review of Enterprises (financed by the Special Project Preparation Facility--SPPF), covering 25 industrial and 15 agricultural enterprises, resulted in initial recommendations in October 1987. A review of four key agricultural subsectors (cashews, irrigation, forestry, and cotton), also financed with SPPF funds, was completed in September 1987 and is providing a basis for operations in the agricultural sector. The Bank initiated a Public Expenditure Review in April 1988, to assess the efficiency pattern of recurrent expenditures and investments. Technical assistance has also been extended in external debt management and reporting.

Mozambique: Social and Demographic Indicators 1/

Area	801.6 thousand sq. km.
Population (1988)	14.9 million
Rate of growth	2.6 percent per annum
Density	
Total land area	17.7 per sq. km.
Agricultural area	30.1 per sq. km.
Population characteristics:	
Life expectancy	48 years
Infant mortality	120 per thousand
Child (aged 1-4) death rate	22 per thousand
Urban population	20 percent of total
Health	
Population per physician	50.7 thousand
Population per hospital bed	1.2 thousand
Access to safe water	
Total population	9 percent
Rural	2 percent
Urban	82 percent
Nutrition	
Per capita caloric intake	1,617 per day
Per capita protein intake	28 grams per day
Education	
Primary school enrollment	83 percent
Secondary school enrollment	6 percent

Sources: Social Indicators of Development, IBRD, 1988.

1/ Unless otherwise indicated, data presented refer to 1986.