FOR AGENDA

EBS/88/40

CONFIDENTIAL

February 25, 1988

To: Members of the Executive Board

From: The Secretary

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

Attached for consideration by the Executive Directors is a paper on a request by the People's Republic of Mozambique for the second annual arrangement under the structural adjustment facility. Proposed decisions appear on page 21.

This subject, together with the policy framework paper for Mozambique (EBD/88/68, 2/25/88), will be brought to the agenda for discussion on a date to be announced.

Mr. R. C. Williams (ext. 7643) or Mr. Niebling (ext. 6943) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF MOZAMBIQUE

Request for Second 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 A.D. Ouattara and H.B. Junz

February 24, 1988

I. Introduction

In the attached letter of the Minister of Finance of Mozambique dated February 23, 1988 (Appendix I), the authorities have described their economic and financial program for 1988 and have requested the second annual arrangement under the SAF in an amount equivalent to SDR 18.3 million (30 percent of quota) in support of it; the initial arrangements were approved on June 8, 1987 (see Appendix II). Discussions for the 1988 program and for the updating of the medium-term economic policy framework took place in Maputo during November 26-December 9, 1987. 1/ An updated policy framework paper (PFP) covering 1988-90, transmitted by the authorities to the Managing Director of the Fund and the President of the World Bank under cover of letters dated February 23, 1988, is being circulated to the Executive Board of the Fund on February 25, 1988 (EBD/88/68). It is being transmitted to the Bank's Executive Board at the same time and is expected to be considered by its Committee of the Whole in mid-March.

With close staff collaboration, the World Bank and the Fund have cooperated in assisting the authorities in addressing Mozambique's economic and financial problems since it became a member of the institutions in September 1984. Two IDA rehabilitation credits, both with bilateral cofinancing, have been approved, the first for the equivalent of SDR 45.5 million in June 1985 and the second for SDR 54.5 million (plus SDR 14.5 million from the Special Fund for Africa) in August 1987. Disbursements from the Bank credits amounted to the equivalents

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1/ The Fund staff team for the discussions comprised Messrs. R. Williams (head), M. Niebling, J. Kakoza (all AFR), W. Hemphill (INST), Ms. M. Carkovic (EP-ETR), and Ms. A. Duran (secretary-BLS). Messrs. R. Grawe, N. Tcheyan, J. Biderman, A. Goudie and Ms. J. Armitage of the Bank staff also participated in many of these discussions.

of US$29.2 million in 1986 and US$61.8 million in 1987. All conditions having been met, the second tranche of the second rehabilitation credit was released in early February 1988. Other Bank Group operations, which include extensive sector work, enterprise and expenditure reviews, technical assistance, and IFC investments, are described in Appendix III.

II. Background and Performance in 1987

During the early to mid-1980s, the Mozambican economy experienced steep declines in production and export levels, and severe financial imbalances emerged. Contributing factors included recurrent drought, the repercussions of regional tensions, and the spread of disruptive violence in varying parts of the countryside; in addition, economic policies proved inappropriate to the emerging circumstances. Partial remedial policy measures adopted in 1983-85 had only a limited effect; the financial crisis deepened and production continued to decline (Table 1 in Appendix IV) 1/. By 1986 large segments of the population were affected by drought and/or dislocation, marketed foodcrop output had fallen to record lows and accounted for little over one tenth of requirements, industry was operating at 20-30 percent of capacity for want of inputs and spares, the country's regionally important rail and port facilities were largely in disrepair and disuse, and its major hydroelectric installation was nearly idle; the national currency had lost most of its value outside of administered channels, and external obligations had fallen heavily into arrears.

In response, the authorities introduced in January 1987 a comprehensive Economic Recovery Program (ERP) for 1987-91 designed to: reverse the economic decline and restore a minimal level of consumption and income, in particular for the rural population; redress domestic financial imbalances and strengthen the country's external payments position; and establish the conditions for more rapid and sustainable growth in the longer run, once security and other constraints eased. Major policy changes and institutional reforms were initiated in macroeconomic areas ranging from the exchange rate, trade, and pricing to public finance and credit, and in key productive sectors such as in agriculture, industry, transport, and energy, giving market forces and incentives a greater role relative to physical planning and administrative allocation. It was recognized that many of the reforms would require a considerable time, and that security conditions would continue to impede reform and recovery. Nevertheless, it was expected that the program would lead to a recovery in production levels, increases in the availability of goods, the virtual reintegration of parallel and

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1/ All statistical tables (Tables 1-8) and a chart are given at the end of the report in Appendix IV. Additional background information and data are contained in the Staff Report for the 1987 Article IV consultation (SM/87/245, 10/21/87) and the accompanying Recent Economic Developments report (SM/87/256, 11/5/87).

official markets, the release and elimination of inflationary pressures, and the restoration of orderly financial relationships, domestically and externally. As such, it would provide a framework for receipt of substantially increased recovery-oriented aid, together with large-scale debt relief to ease the strain of adjustment and facilitate recovery. The ERP became the basis for the policy framework and programs underlying the initial SAF arrangements with the Fund and the second IDA rehabilitation.

Major corrections in the exchange rate and official domestic prices took place during 1987, with the metical devalued from some Mt. 38 per U.S. dollar to Mt. 200 (buying) at the end of January and to Mt. 400 in late June, 1/ fixed prices typically raised by 300-500 percent (less for a few rationed staples) and price controls eased while general wage increases (apart from productivity increases) were held to 50 percent after each devaluation. With tight demand-management policies also in place, these measures achieved an early and substantial reduction in the extent of parallel markets and the degree of divergence in the price structure. The parallel-market exchange rate in Maputo reportedly declined from Mt. 1,500-1,800 per U.S. dollar in 1985-86 to about Mt. 900 by late 1987, while most parallel-market prices for goods reportedly remained stable or eased somewhat, as did the free-market prices of fruits and vegetables. Overall, consumer prices appear to have averaged approximately 125 percent higher than in 1986, and somewhat more for lower-paid workers relatively dependent on rations at official prices. 2/ On the other hand, there was also an improvement in the supply of essential goods, which had been scarce or unavailable at earlier official prices. Wage levels averaged some 100-110 percent higher in 1987 than 1986, albeit only about 80 percent higher for those receiving the general increases alone. Unemployment rose, as there were significant reductions in work forces on a number of state farms, in some other enterprises and in the civil service (by 10 percent in Maputo). Hence there appears to have been some decline, although difficult to quantify, in real incomes of city dwellers in 1987, even as the potential real incomes of rural producers were increased substantially.

The 1987 government budget included a substantial revamping of the domestic tax code to enhance and accelerate revenues, the assumption from the banks of responsibility for financing enterprise operating losses, and tight caps on these and other current outlays. Actual revenue collections are estimated to have more than tripled in nominal terms, with tax revenues nearly quadrupling (Tables 1 and 3). While

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1/ A further devaluation took effect January 1, 1988 to Mt. 450 (buying) per U.S. dollar. See EBD/88/31, January 22, 1988.

2/ Estimates vary widely, depending on the weight given parallel-market transactions and the base period chosen. Preliminary official estimates, which in principle reflect parallel-market as well as official-market transactions, put the increase at 165 percent. The increase in the GDP deflator is estimated at 140 percent.

current expenditure more than doubled (inclusive of enterprise subsidies), capital outlays rose about sevenfold, as did the aid flows largely financing them (reflecting mainly exchange rate effects); thus, total outlays rose about as rapidly as revenues, but external financing rose twice as fast as either. Actual revenues turned out some 15 percent short of initial projections, owing mainly to early lags in implementing price increases and to unexpected production bottlenecks for highly taxed beverages and tobacco, but the shortfall was offset by savings on most nondefense current expenditure items, including wages and subsidies; in particular, enterprise subsidies were considerably below the program maximum. Hence the current deficit is estimated to have been held to the targeted Mt. 25 billion, compared with Mt. 21 billion (including enterprise subsidies) the year before. Since capital outlays fell somewhat short of projections, the overall deficit before grants was well within the program target (at an estimated Mt. 98 billion against a targeted Mt. 104 billion), although it rose marginally relative to total expenditure (to 59 percent); on an after-grants basis, financing requirements fell considerably relative to total expenditure (from 51 percent to 36 percent). With the capital budget fully covered by grant and net loan inflows, recourse to domestic bank financing in 1987 is also estimated to have been kept to the same level as the current deficit, i.e., the targeted Mt. 25 billion.

The level of interest rates was approximately tripled at the beginning of 1987, to around 20 percent for one- to two-year loans in favored sectors and 18 percent for one- to two-year deposits, and lending policies were revised to emphasize commercial criteria and performance. A new plan of accounts for the banking system was given final approval in April 1987 for complete implementation by end-1988, and initial steps were taken toward separating the commercial and central banking functions of the Bank of Mozambique. Domestic credit growth, targeted to reduce the overhang of domestic liquidity from past excessive expansion, amounted to an estimated 31 percent in 1987, with credit to the economy (enterprises, etc.) rising by 20 percent (Table 4). These increases include amounts on-lent to enterprises from long-term funds borrowed abroad, which were excluded from (additional to) the SAF program targets. The latter are estimated to have been met for the year as a whole, as were the quarterly credit benchmarks under the program. Money and quasi-money grew by an estimated 49 percent, modestly more than targeted (44 percent).

With respect to external transactions, substantial progress was made in 1987 toward regularizing debt service and mobilizing additional resource inflows. Debt relief was arranged in principle with London Club banks in late May (covering some US$250 million, almost all arrears) and in mid-June with Paris Club participants (some US$360 million, including 1988 maturities). Agreements with other creditors are expected to provide substantial further debt relief for 1987-88 (about US$965 million). Mozambique has been seeking concessional interest rates in bilateral negotiations with official creditors, since the debt service burden remains high even after comprehensive relief on conventional interest terms. Among major creditors, the authorities report that bilateral agreements have been concluded with Italy (at 1.5 percent interest) and the Soviet Union (at zero percent), while the final agreement with London Club banks was nearly ready for signature in February. 1/ Discussions have been initiated with most other creditors and concluded with some, but those with most Paris Club creditors are proving lengthy in view of resistance to concessional interest terms; the target date for completion of the Paris Club bilateral agreements is June 30, 1988. Aid flows in 1987 were augmented through a UNDP-sponsored food-donor conference at end-March and a Consultative Group meeting in mid-July. Contracts and guarantees for nonconcessional external loans of 1-12 years' maturity were held to about US$14 million in 1987, well under the agreed US$20 million limit. Although Mozambique continues to maintain comprehensive restrictions on the making of payments and transfers for current international transactions, they were eased somewhat during 1987 by permitting enterprises to import and export directly as well as through established trading companies, and by reducing substantially the number of products under control of trading monopolies. The exchange retention scheme was expanded to include nontraditional exports, with product-specific retention rates, and provision was made for automatic participation.

Balance of payments developments turned out largely as anticipated under the program in 1987 (Table 5), with exports, imports, the current account deficit and loan disbursements rising to about their projected levels, 2/ despite earlier expectations of shortfalls in loan disbursements and imports; grant receipts proved higher than anticipated but so did debt service obligations. In particular, imports, whose decline had already been reversed the year before, rose further in 1987 (by 18 percent, to some US$640 million). Although external grant and loan disbursements reached nearly US$660 million, an overall deficit of some US$450 million was registered, which, together with the virtual elimination of arrears, was financed by debt relief. A larger-than-expected increase in reserve assets occurred, but much of it was transitory, largely representing aid funds deposited late in the year against forthcoming import payments.

Largely as a result of the measures taken and the substantial aid inflows, the economic decline of the first half of the decade appears to

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1/ Delays in signature, due in part to data reconciliation, appear to have led to delays in settlement of interest due, which will need to be resolved in concluding the final agreement.

2/ For comparability, it is necessary to revise the program figure for the current deficit upward to reflect some US$55 million in previously unrecorded service payments financed from project loans.

have been reversed in 1987. 1/ Activity in light industry in particular benefited from improved supplies of imports and spares, and in agriculture there was some upturn in the marketed volume of cereals. It is estimated provisionally that real GDP rose by 3-4 percent in 1987, that the real level of gross investment was maintained even though one of the two major dam projects was completed, and that average per capita consumption also rose, partly in reflection of food aid inflows. On the other hand, dislocations persisted in numerous rural areas, and in the cities and towns unemployment rose.

The implementation of financial benchmarks under the 1987 SAF program is shown in Table 8, and performance in relation to the main 1987 structural benchmarks is indicated in the policy matrix (Table 1) attached to the updated PFP. As noted above, credit and other quantitative benchmarks were observed, including budgetary targets for the overall deficit and enterprise subsidies. Also, all of the numerous structural and other measures programmed for 1987 were put in place essentially on schedule. 2/ More time than initially anticipated has been needed for the changeover in the banking system's accounting plan and improvements in external debt information. All benchmarks central to the program were implemented, including the major exchange rate, pricing, labor, taxation, and interest rate measures that were accomplished well before approval of the SAF arrangements, as well as the subsequent mid-year and year-end exchange rate adjustments, further increases in fixed and "conditioned" prices, reductions in the number of items with centrally fixed prices, reductions in the number of products subject to administrative allocation domestically, reductions in the extent of export and import monopolies, the initiation of debt rescheduling procedures, and the completion of several major studies looking toward policy measures in 1988.

III. Medium-Term Policies and Prospects

1. Principal objectives, features, and constraints

The authorities' overall objectives for 1988-90 under the ERP remain fundamentally unchanged from those enunciated at the outset of 1987. Structural reforms that improve incentives for production and marketing and provide for more flexible and efficient resource allocation will continue to be complemented by prudent macroeconomic policy

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1/ GDP estimates as well as price indicators remain problematic in Mozambique. The real growth rates alluded to here represent averages of those from the official, expenditure-based estimates and from World Bank staff value-added estimates, which are lower.

2/ The measures pertaining to 1987 specified in Table 1 (the policy matrix) of the original PFP were benchmarks according to the arrangement; many were also taken within the purview of the IDA rehabilitation credit.

management. Over the course of the program period ongoing reforms are designed to reduce progressively administrative controls and intervention to the extent permitted by the security situation, to permit allocation to be based more on market-determined prices, to provide a greater role for credit policy and other indirect means of guiding the economy, to encourage private enterprise, to link incomes more closely with performance, and to improve the planning and policy process underlying public expenditure.

The constraints and obstacles faced in pursuing these medium-term objectives are formidable, and extend beyond the security situation. Distortions and imbalances have become complex and intertwined over time, and reform involves not only revisions in announced prescriptions but changes in the attitudes and habits of economic agents. Although Mozambique's natural resource endowment is favorable, the country's technical, professional and managerial skills remain in extremely short supply, impeding the implementation of decentralized management and obliging the authorities to give high priority to education and related social development. Moreover, the uneven impact of adjustment calls for directing attention and resources toward cushioning the transitional costs, especially for the poorest. The continuing insecurity and disruption in varying parts of the country, nevertheless, remain the most pressing concern. As before, the security situation is assumed to remain essentially unchanged for purposes of economic policy and projections. As such, however, it imposes a heavy burden on the economy, making additional claims on resources while undercutting production and the revenue base severely. It also works against achievement of the full benefits of an economic strategy based in important part on shifting relative incentives in favor of rural producers and giving them a renewed stake in the official market economy so as to stimulate increased supplies of foodcrops, export products, and industrial inputs.

Despite these constraints and impediments, it is expected that with continued timely implementation of reform measures and sufficient financial support from the international community on concessional terms, a fairly strong pace of economic recovery can be maintained during the program period and beyond, and that price increases will decelerate sharply. Moreover, the external accounts can begin to strengthen appreciably, even if balance of payments viability remains a much longer-term objective. Quantitative medium-term targets in this respect are a real growth rate averaging 4-5 percent, an inflation rate on the order of 15 percent by 1990, a downturn in the overall balance of payments deficit, and a modest but sustained rise in reserves. With these factors in mind, and to establish the basis for sustainable economic growth once the security situation improves, the authorities are determined to maintain the pace of economic reform as set forth in the PFP.

2. Exchange management, prices, and wages

Progress toward a realistic exchange rate, flexibly managed, remains a priority feature of the program, with the aim of evolving a more open and efficient exchange and trade system as earnings and aid flows permit. So far, while the differential between the official and parallel rates has been large, the gap has been the primary indicator of exchange rate policy, and the authorities have preferred to use large stepwise changes to accomplish most of the needed correction; in the near future, however, with the gap narrowed substantially, conditions will be appropriate for flexible management according to a more comprehensive set of criteria. A phased reduction in the scope of administrative foreign exchange allocation is to accompany the movement of the exchange rate, with a small nonrestricted import list being introduced and expanded gradually. With exchange rate actions restoring the importance of the customs tariff, an initial simplification is planned with more comprehensive revision to follow, which should facilitate reductions in quantitative restrictions. Interim trade and exchange management mechanisms will be refined in 1988, but their role is expected to decline in later years as more open, price-based allocation expands.

In addition to reducing the scope and rigidity of price and distribution controls, the authorities are seeking to restore appropriate cost-price relationships for products that remain subject to regulation. A major step in this regard is the sharp increase in the prices of basic consumer staples planned for early 1988, with a substantially offsetting wage increase of a uniform amount per worker (see section IV). This action will not only reduce budgetary subsidies for domestically produced staples but also value more appropriately the much larger amounts of food aid being provided to domestic markets. The authorities' objective is to eliminate the gap between actual economic costs and consumer prices, so as to avoid further distortions in incentives for production and marketing and to preclude open-ended claims on the budget. Controlled prices will, moreover, continue to be adjusted for full pass-through of exchange rate adjustments, while the number of items subject to centralized price fixing is to be reduced further, eventually to only a few staples. At the producer level, experiments will begin with a system of floor prices for certain crops, with the state marketing agency acting as buyer of last resort. Additional products are to be freed from price control, as have been fruits and vegetables since 1985 with favorable results on supplies. Although the "conditioning" regime will continue to apply for the time being to all goods not expressly fixed or freed, official review will continue to be ex post only, and the authorities anticipate that the system can be phased out as supply conditions and competition improve. In distribution, increased competition is being encouraged and further reductions in the scope of administrative allocation are under study.

Incomes policy continues to favor rural producers. The authorities aim to hold average wage adjustments to no more than anticipated increases in the cost of living, which in turn are expected to decelerate markedly over the program period. While it has proven administratively difficult to refine the targeting of food subsidies, efforts to buffer the costs of adjustment and dislocation for those most affected are to be stepped up, with additional measures being set in motion to assist the unemployed, refugees, and other vulnerable groups.

3. Public finances and credit policy

A continued strengthening of public finances remains central to the program, in both its macroeconomic and structural aspects. In particular, it is considered essential that budgetary financing avoid crowding out the productive sectors' growing credit requirements. The key policy areas remain: strengthening the revenue base, containing current expenditures, instilling financial discipline and profitability among enterprises, and setting and holding to priorities for investment and aid in terms of rehabilitation. Following the reforms of domestic taxation in 1987, the revenue focus is shifting to customs tariff reform (see IV.3., below) and to improvements in customs and tax administration, which should augment the positive effects on the tax base of recovery and the absorption of parallel markets.

A restrained wage policy and continued austerity in purchases of goods and services will contribute to limiting current expenditure growth. Reductions in subsidies to enterprises are being made possible by the effects of the price rationalization policies, by economic recovery, and by specific actions addressing severe cases. The review of 40 agricultural and industrial enterprises and more detailed studies of 5 of these carried out under World Bank sponsorship in 1987 have provided initial company-specific proposals for restructuring and rehabilitation. A technical support unit is being established in the Ministry of Finance, with local and international staffing, to advise enterprises on management and finance and to provide detailed evaluations and plans for improvements, divestiture and closure. The capital budget is being reoriented to emphasize rehabilitation and maintenance; the program incorporates significant real increases in investment levels, in reflection of the considerable rehabilitation requirements and the availability of highly concessional external resources. A comprehensive public expenditure review, being undertaken with World Bank participation, is to provide initial recommendations by mid-1988 for the 1989 budget and planning cycle and will continue to assess procedures and effectiveness thereafter.

The improvements in the key areas of fiscal policy should be reflected quantitatively in a decline, even in nominal terms, in government recourse to the banking system and a reduction in the current account deficit, first in relation to revenues and in real terms and subsequently in absolute terms. The overall budget deficit is being driven mostly by capital outlays, which are rising not only in real terms due to rehabilitation requirements but also at a disproportionately fast rate in nominal terms because of the effects of major exchange rate corrections on their largely external composition and financing. The ratio of the overall deficit after grants to total expenditures may well rise initially to over 60 percent, but a modest decline can be expected in the medium term, once exchange rate effects and large investment increases begin to work through. On the other hand, given anticipated grant levels, the ratio on an after-grant basis began to decline in 1987 and should continue to do so. The current deficit is also expected to continue declining relative to revenues. The authorities have in fact set its elimination as a target for 1990; achievement of such an objective will require strenuous efforts, as it implies raising the ratio of revenues to current expenditures from around 75 percent in 1987-88 to unity by 1990, but it could be accomplished largely by raising revenues to their former share in GDP and eliminating most subsidies. 1/ An immediate and continuing reduction in recourse to the domestic banking system is foreseen, moreover, as increases in grant receipts (reflecting higher valuation of food aid as well as exchange rate effects) augment the results of revenue and expenditure measures. Having fallen from 39 percent of total expenditures in 1986 to 15 percent in 1987, domestic bank financing should decrease to 1-2 percent by 1990, even if food aid inflows diminish.

Monetary and credit policy needs to continue for the time being to avoid accommodating fully the upward movement in the price level that could result from correction of official prices, so as to preclude an inflationary spiral and ensure the targeted deceleration in prices. With the sizable absorption of excess liquidity through the tight rein held on credit in 1987, however, greater leeway now exists to facilitate continuation of needed economic recovery during the remainder of the program period. Annual credit programs and quarterly benchmarks are being maintained on a basis consistent with financial savings flows and inflation and external objectives. Measures of a structural nature include full implementation of the new plan of accounts, concomitant statistical improvements, refinements in bank operations and training, steps to regularize or write off bad debts, the enhanced application of commercial criteria in credit extension, the establishment of specialized funds for agricultural credit, and the formulation of plans to introduce means of credit control less direct than explicit ceilings. Most of these measures are supported by Fund and/or Bank technical assistance and should contribute to a steady, if not readily measurable, improvement in institutional capabilities.

Although interest rates remain considerably below the average rates of price increases in 1987 and 1988, the measured price "inflation" reflects mainly the rapid correction of severe price distortions. The recent relative price stability in parallel goods markets and the expectations of much lower price increases later in the program period suggest that it is feasible to reach the program objective of positive real interest rates within the period. For the time being, emphasis is on institutionalizing the payment of interest and simplifying the rate structure, while keeping its level and flexibility under active review.

1/ Although references to GDP require caution in the context of rapidly changing relative prices and a weak statistical base, they add concreteness here. Thus, it may be noted that revenues, which amounted to 16 1/2 percent of GDP in 1987, exceeded 20 percent in the early 1980s, and that while current expenditures were 22 1/2 percent of GDP in 1987, subsidies alone accounted for 4 percent.

4. Balance of payments and debt management outlook

Given the resource requirements for recovery and the anticipated levels of external assistance, prospects are for the external current account deficit (before grants) to continue widening over the next several years, but for the overall deficit to decline gradually after 1988. Joint staff projections through 1992 (Table 5) indicate that Mozambique will require continuing substantial debt relief or other exceptional financing throughout the program period and beyond. Debt service obligations (before relief) remain around US$500 million per year (Table 6), while the projected overall deficit declines from just under that level in 1988 to, indicatively, US$365 million by 1992.

For 1988, the overall deficit of some US$495 million would represent a moderate widening from the 1987 level. Reflecting rehabilitation needs and accelerating recovery, imports are forecast to rise by 12 percent in volume terms, or by 17 percent in U.S. dollar terms, to US$750 million. Export earnings are expected to rise at an even more rapid rate of 22 percent, mainly on the strength of volume growth in cashews, but to reach only US$105 million--or 37 percent of the 1980-81 peak value. Furthermore, as a result of the recent reduction in employment of Mozambican miners in South Africa, service earnings are projected to decline in 1988, and the deficit on services (including interest due) to rise considerably. Thus, the current account deficit is expected to rise by about US$130 million in 1988, to some US$895 million, of which about $400 million (45 percent) would be covered by grants and a small net loan inflow. Below the line, no change in reserves is envisaged, although the transitory gains of late 1987 are to be recouped by end-1988. Debt service rescheduling already agreed or in process is put at just under US$400 million, while the second SAF loan would provide another US$25 million. As discussed more fully below (IV.5), additional financing sufficient to cover the remaining US$70 million is clearly in prospect.

For 1989 and beyond, export recovery is expected to continue at a rapid although decelerating pace, import growth to slow gradually, and the services deficit to stabilize despite growing interest obligations. Export growth is projected to continue to exceed 20 percent in U.S. dollar terms through 1990 (Table 1), but then slow somewhat, with increases in unit values accounting for only 4-5 percent a year; supplies of cashews, which are quite responsive to producer price incentives, are expected to continue recovering strongly, but little volume growth is expected from prawns, the other leading export, owing to natural constraints. Import growth is projected to decelerate to less than 10 percent in value terms after 1990, with average price increases continuing at some 3-4 percent. Nevertheless, the trade deficit would continue to increase slowly. Ordinary grant and loan receipts are assumed to grow by 7 percent annually in U.S. dollar terms. In addition, Mozambique is one of the 14 countries eligible for participation in the World Bank's Special Program of Assistance for low-income, heavily indebted African countries, and therefore the projections incorporate additional inflows from new initiatives averaging US$100 million during 1989-92. Without such additional resources, the growth of imports (and hence the pace of economic recovery) would have to be curtailed unduly. The projections also incorporate as a policy target an increase in reserves of about US$25 million per year--to reach the equivalent of two months' imports by 1991--which would 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 1988, debt service obligations before debt relief are equivalent to 240 percent of expected current earnings, and even with projected strong increases in earnings, this ratio would be reduced only to 150 percent by the early 1990s. After debt relief, actual debt service payments in 1988 are placed at 58 percent of earnings. With continued rescheduling on terms comparable to those assumed for 1987-88, the debt service ratio is likely to rise as the amount of "reschedulable" debt diminishes and interest on amounts already rescheduled grows. On these assumptions, the unfinanced gap would increase gradually to some US$145 million by 1992, an amount approximately the same as interest payments falling due on refinancing credits. 1/

IV. Program for 1988

1. Main emphases and targets

In 1988, the rate of recovery in GDP is projected to accelerate to nearly 6 percent, reflecting increases in smallholder farm output in response to the enhanced incentives and further gains in manufacturing capacity utilization, as well as increased freight traffic, construction, and commercial activity. Despite further large adjustments in official prices, the rise in average consumer prices is projected to slow to some 70 percent (63 percent for the GDP deflator) for the year as a whole; by year-end the annual rate should be well below this level. The process of regularizing relations with creditors is expected to be completed in 1988, with no new payment arrears accumulated and an increased level of reserves maintained. Specific structural and financial measures for 1988 will focus on further reductions in price distortions, the easing of administrative impediments to growth and efficiency and the strengthening of public sector finances and management in the framework of restrained demand management. Benchmarks for monitoring

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1/ The outcome is of course sensitive to changes in assumptions, e.g., a 1 percent change in the interest rate on refinancing credits would have an average effect of US$13 million on the financing gap. Also, a 1 percent slower growth in grants and loans after 1988 would produce a cumulative reduction in imports of US$87 million, an amount similar to the projected increase in reserves during the period.

the implementation of structural and financial policies are listed in Tables 1 and 2, respectively, of the attached letter of request (Appendix I).

2. Exchange system, prices, and wages

The third adjustment of the official exchange rate, to Mt. 450 per US$1 (buying), effective January 1, 1988, brought the cumulative depreciation of the rate in foreign currency terms to 91.5 percent in less than a year, and reduced the gap between the parallel and official rates to 50 percent. Specific understandings have been reached regarding further substantial reduction in this gap by mid-1988 and flexible management of the official rate thereafter that would, as a minimum, prevent the gap from widening again. More comprehensive criteria and modalities for flexible exchange rate management are to be worked out with the staff during the year for introduction by 1989. With a view to further easing of exchange and trade controls, the beginnings of an open general license procedure will be introduced on a modest scale for selected goods shortly. Meanwhile, interim trade rationalization measures are being refined: procedures for more frequent and systematic review of foreign exchange availabilities and priorities, developed in 1987, are being introduced in early 1988; the average level of export retention rates is being reduced somewhat; and limited resale of "own exchange" imports will be permitted. In addition, customs tariff reform is to be initiated during the year.

With respect to prices, the authorities have already made public their intention to raise prices of subsidized staples sharply and grant a largely compensating uniform wage increase when the 1988 budget was presented to the People's Assembly in December 1987. Specific price increases, which are expected to be announced at the end of March, are expected on average to roughly triple the prices of the main rationed goods in Maputo and Beira, where they have been most highly subsidized. Consumer prices would thus be brought well above comparable producer prices, although not yet fully up to delivered costs. Principal agricultural producer prices for the 1987/88 season were already announced in late 1987; typically they entailed increases of 50-75 percent over the 1987 levels, bringing the cumulative rises since 1986 to 350-600 percent (950 percent for cashews); further increases are anticipated in late 1988. The number of product groups subject to centrally fixed pricing was reduced from 37 to 32 in January 1988 1/ and is to be progressively reduced to 25 or fewer by year-end, while those still fixed will be adjusted to reflect future exchange rate changes. In addition, rent increases in nationalized housing, which were considered but deferred in 1987, are gradually being put into effect beginning in early 1988. Nevertheless, as noted above, the extent of absolute and relative price changes should be considerably less in 1988

1/ Pesticides and cement were transferred to the "conditioned" list and the prices of potatoes, lambs, and goats were freed.

than in 1987, given the major exchange rate corrections already accomplished as well as expected increases in capacity utilization and marketed agricultural output.

The uniform wage increase is expected to go into effect the month before the staple price increases, to be reflected in end-month pay. The amount is being calculated to approximate the increase in costs of these staples for a household with one wage earner per three members. Although the percentage increases will be highly tapered, the average is indicated roughly by the estimate that it will increase the civil service wage bill by about 20 percent from its end-1987 monthly rate. The authorities anticipate a further but smaller and proportional general wage adjustment in mid-1988 that would roughly keep wage earnings in pace with living costs.

3. Public finance

Fiscal measures for 1988 are concentrated on further improvements in the revenue structure and the curtailment of subsidies. The customs tariff and its administration have been identified for urgent attention, while progress in domestic taxation and tax administration will be maintained. A Fund fiscal mission in late 1987 added several recommendations to the ongoing internal reviews. One result is the first-round tariff reform, which is to be readied during 1988 for implementation by year-end. Although meant to be revenue-neutral, it will simplify greatly the myriad of rates and duties, streamline administration, and facilitate analysis and adjustments for revenue or trade management purposes. A package of revenue measures, designed to raise at least Mt. 10 billion (equivalent to 8 percent of projected 1988 revenues), will also be prepared by mid-year for introduction with the 1989 budget; however, if a shortfall develops against program targets, it will be introduced several months earlier. Action is also anticipated on reducing customs duty exemptions, converting specific duties to ad valorem, and eliminating most nuisance-value export duties.

The increases in staple prices are expected to reduce budgetary outlays for consumer subsidies to some Mt. 3-4 billion in 1988, or about one third of their 1987 level in real terms. Although the concurrent increase in the year's civil service wage bill will be slightly larger, the increased local currency sales proceeds from external food aid supplied to local merchants will add several billion meticais to grant receipts for the budget. 1/ Subsidies to cover enterprises' operating losses are budgeted at Mt. 12 billion, which represents a further significant decline in real terms. Together, consumer and enterprise

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1/ Budgetary grant receipts reflect only the local counterpart generated by sales of these donated imports; other food aid, given away as relief (mainly in rural areas) is not reflected in the budgetary accounts. Budgetary subsidies pertain only to local production marketed through official supply channels.

subsidies account for only 5 percent of total budgetary expenditures under the 1988 program, compared with 10 percent in the estimated 1987 outturn. In light of the wage adjustments and reductions in force during 1987, the authorities expect to hold the increase in the 1988 civil service wage bill to 70 percent, the rise anticipated in average consumer prices. 1/ By contrast to other current expenditure items, total interest payments incorporated in the budget are projected to more than triple in 1988. This reflects the institution of more regular payments procedures for external interest due (through a special account set up in late 1987), the effects of exchange rate adjustments, and an increase in the interest rate on most of the Government's domestic debt, from 3 percent to 8 percent.

The broad quantitative results are that revenues are projected to rise by just over three fourths in nominal terms (without the Mt. 10 billion revenue package) and current expenditures by just under two thirds. Despite the higher growth rate for revenues than current expenditure, the current deficit is expected to increase by Mt. 10 billion (40 percent), to Mt. 35 billion. This nominal increase, however, is less than the effect of the disproportionate increase in interest outlays and represents a decline both in real terms and relative to revenues. The authorities have indicated that available concessional external financing could well permit the level of capital outlays to more than double. If so, the growth rate of total expenditure would exceed that of domestic revenues, and the overall deficit/expenditure ratio before grants would increase somewhat, to as much as 63 percent. 2/ The containment of the current deficit and the combined effects of valuation changes and real increases on external aid receipts will, however, permit a reduction in government recourse to the banking system to a targeted Mt. 20 billion, or from 15 percent of total expenditures in 1987 to 6-7 percent in 1988. The amount would be equivalent to less than 12 percent of the opening stock of money and quasi-money.

4. Money and credit

The credit program for 1988 is based on a projected growth of 43 percent in broad money with no significant changes in net foreign assets and net unclassified items other than valuation effects. Consistent with these projections, the growth of aggregate domestic-source bank credit is to be limited to Mt. 74 billion (33 percent), accounting for the full amount of monetary expansion. Of this amount, no more than

1/ Even without any pay increases in 1988, the year's wage bill would be about 35 percent higher than that of 1987, i.e., the December 1987 wage bill was this much higher than the average monthly wage bill for 1987. From December 1987 to December 1988, the increase is projected at 37 percent.

2/ A 20 percent shortfall in capital outlays, which would not be unusually large, would, ceteris paribus, lead to a slight decline in the overall deficit/expenditure ratio, to 58 percent.

Mt. 20 billion, a little more than one fourth, is to be used for financing the government budget deficit, compared with nearly one half in 1987. Additional amounts will be made available to the economy (nongovernment sectors) through the on-lending of concessional long-term loans channeled through the Bank of Mozambique, mainly from the IDA rehabilitation credits.

The new system of accounts for the banking system will be fully in place by the end of 1988. In addition, a review is being undertaken of the substantial amount of nonperforming loans held by the banking system, with the aim of regularizing or writing off some of this debt during 1988; as part of such a plan, the Government would assume the bad debt of some enterprises whose default was caused by factors beyond their control. Emphasis continues on the application of commercial criteria in credit approval. A simplification of the mandated interest rate structure, which will allow banks greater latitude in the pricing of lending for risk, is anticipated during the course of the year. An adjustment of the level of interest rates, aside from that on government debt, is not foreseen in the near term, with efforts concentrated during 1988 on institutionalizing the timely payment of amounts due.

5. External finance

The external financing assumptions for 1988, based on the projections discussed earlier, include some US$720 million in concessional assistance already committed for the year, and an estimated US$400 million in debt service rescheduling. The proposed SAF loan would add the equivalent of US$25 million, and a remaining US$70 million in new commitments would complete the financing of the program for 1988. The US$70 million of additional financing will be covered mainly by new resources from initiatives being taken by the multilateral and bilateral donor community under the auspices of the World Bank's Special Program of Assistance for Low-Income Debt-Distressed African Countries, details of which should be known at the time of the Board meeting. While negotiations with these financing sources are under way and commitments remain to be confirmed, additional financing for 1988 can also result from the improved terms for debt service currently being negotiated and from the small amount of nonconcessional borrowing permitted under the program. The authorities are determined to preclude a re-emergence of arrears.

V. Staff Appraisal

The Mozambican authorities have vigorously implemented the comprehensive Economic Recovery Program (ERP) launched in 1987, which has drawn widespread support from the international community. The ERP was designed to effect wide-ranging structural economic reforms, restore the predominance of official markets, and correct economic distortions and financial imbalances. The policy actions implemented or initiated during 1987 constituted important steps toward the achievement of these objectives. The decline in output that characterized the early 1980s appears to have been reversed, major progress has been made toward correcting domestic financial imbalances, and Mozambique has begun to regularize its relations with creditors. The strong adjustment in relative prices and the easing of administrative controls have helped to reduce the role of parallel markets. All quantitative financial benchmarks have been observed, according to preliminary data, and with very minor exceptions all the structural and other measures set out under the 1987 program were implemented fully and on schedule. However, and as anticipated from the outset, the economically disruptive security situation and the deep-seated nature of the economy's structural problems have precluded early declines in the overall domestic resource gap and external deficit.

Assessment of the authorities' adjustment efforts should therefore give considerable weight to the quality and scale of the underlying structural and macroeconomic policies in the program, and to the record of their implementation. It is against the background of positive achievement and with the ERP's basic objectives and strategy essentially unchanged, that the original PFP was updated for the period 1988-90. Within this framework, the program for 1988 continues the reform and adjustment momentum achieved in 1987. The authorities' decision to reduce consumer subsidies sharply early in 1988 represents a much more rapid pace of adjustment than originally envisaged. The compensating uniform and hence highly tapered wage increase, while not an appropriate longer-term model in view of the extent of unemployment and lack of skilled manpower, is both sensitive to the social requirements of adjustment and consistent with the fiscal aspects of the program.

Fiscal policy in 1988 continues to reflect the momentum of structural reforms and the serious exogenous difficulties facing the Mozambican economy. Public expenditures are driven by enormous defense, rehabilitation, and development requirements, while the domestic revenue base has been seriously eroded by the security situation and several years of economic decline. In response, the fiscal program aims to strengthen the revenue base, limit the growth of current expenditure, improve the quality of public capital expenditure, and reduce the budget's overall recourse to bank financing. With respect to the first of these objectives, the staff welcomes the authorities' intention to revise the customs tariff, reduce duty exemptions, and prepare a package of new revenue measures. It would, however, urge that the new revenue package be implemented even before 1989 in order to expedite the achievement of the program's fiscal objectives.

The staff is also encouraged by the continued reduction in enterprise subsidies programmed for 1988. The recent review of selected public enterprises and the establishment of a technical support unit should provide the basis for improvements in enterprise management and finance and specific rationalization measures, which should now be given a high priority. Equally important is the forthcoming review of public expenditure to be conducted in cooperation with the World Bank. This review needs to be carried out fully and on schedule to better ensure that the large-scale capital expenditure program contributes sufficiently to strengthening growth prospects and balance of payments and external debt management. In this regard, the staff also strongly supports the authorities' request for technical assistance from the Fund in reviewing and strengthening budgetary expenditure control.

The large overall budget deficit (before grants) for 1988 and beyond is a measure of the overall shortage of domestic resources and is expected to decline only moderately in relation to total expenditure during the next two years. Nevertheless, the actions planned for 1988 to reduce subsidies, strengthen public enterprises' financial management, contain the civil service wage bill, regularize interest payments, increase the revenue base and rationalize further public sector expenditure, will contribute substantially to the strengthening of public sector finances in Mozambique. Their implementation represents a significant indicator of the strength of the adjustment program. The increase in prices of subsidized staples both heads off a potential long-term burden on the budget and increases the local currency value of external food-aid grants. The increment in the nominal level of the current budget deficit (before grants)--limited roughly to the amount of additional government interest payments--is covered without recourse to additional borrowing. The staff welcomes the further progress in reducing borrowing from the domestic banking system to less than half of the 1987 level in real terms, as it will permit an appropriate increase in the scale of credit flows to other sectors while aggregate credit expansion is limited to an amount consistent with macroeconomic objectives.

In the financial sector, the staff welcomes the authorities' continued implementation of measures to strengthen the banking system and to rely more on commercial criteria for evaluating credit requests. This process will be assisted generally by measures to ensure the timely payment of interest and by the increase in interest on government borrowing. Although bank lending and deposit interest rates were significantly increased in 1987 at the outset of the program, their adequacy should be kept under review. Given the large adjustments in official prices under way, it is difficult to determine the underlying rate of inflation, although the behavior of prices in parallel markets suggests that it has been fairly moderate since early 1987. In these circumstances, the staff can accept the authorities' view that it is more important, for now, to concentrate on the institutionalization of the practice of paying interest charges and to begin rationalizing the structure of loan rates. As large adjustments in fixed prices end and the operating environment in the enterprise sector becomes more commercially oriented, the opportunity should be taken to permit interest rates to become better aligned, if necessary, with the underlying rate of inflation. Moreover, although present deposit rates may be sufficient after price distortions have been eliminated, consideration should be given now to removing upper limits on most bank lending rates to ensure adequate scope for risk differentials.

Exchange rate policy was implemented as planned during 1987 and early 1988. Additional adjustment is expected to ensure that the differential between the official and parallel market rates narrows considerably further during the course of 1988. The staff believes that these policies are consistent with attaining broad program objectives. The planned review of exchange rate policies with the staff during 1988 will help the authorities formulate the modalities for flexible exchange management after the large stepwise adjustments have been completed. The staff welcomes the planned introduction of a free import list in 1988, which, although necessarily modest in scope at the outset, is an important initial step in a phased reduction of reliance on quantitative import restrictions. This process will be facilitated by the customs tariff reform envisaged in the program and by the policy of flexible exchange rate management.

With respect to the medium-term outlook, the formulation and implementation of economic policies thus far have led to an acceleration of the projected economic recovery. A steady growth in real imports to facilitate this process is assumed, reflecting the continued strong support of the international community for Mozambique's economic program. While a substantial recovery of exports is also expected--at a much higher rate than that of imports--the current account deficit would widen during the program period, owing to the magnitude of the initial imbalance. Nevertheless, the overall balance of payments deficit is expected to peak in 1988 and decline steadily afterwards, and along with it, the magnitude of the required exceptional financing. Although medium-term balance of payments viability is not to be expected--barring alleviation of security problems--the external accounts will be manageable as long as Mozambique perseveres with its economic program and continues to draw widespread international support for its policies.

In addition to the large-scale concessional aid commitments assured for 1988 and debt relief arrangements being concluded, the staff is encouraged by the initial responses of the donor community to the Bank's Special Program of Assistance for Low Income Debt-Distressed African Countries. It is hoped that the additional resources available in 1988 will permit strengthening Mozambique's external reserve position and allow it to stay comfortably below the limit on nonconcessional borrowing for the 1988 program. Additional debt relief and aid, bolstered by the new initiatives now being put in place, should be adequate to cover the projected external financing gap during the remainder of the SAF arrangement. Although the balance of payments situation will remain difficult over the medium term, the continued support of the international community, along with the improved economic performance resulting from the measures that are being implemented, should enable Mozambique to make timely repayments of SAF loans and avoid a renewed emergence of payments arrears. With respect to the exchange restrictions evidenced by external payments arrears, in consideration of Mozambique's progress in their elimination, the staff proposes the temporary approval of their retention.

Mozambique's Economic Recovery Program represents a comprehensive effort by the authorities to address the country's economic problems in circumstances that are extraordinarily difficult. The program for 1988 consolidates the gains achieved last year while broadening and strengthening important policy reforms. In the staff's view, it warrants the Fund's continued support. Under prevailing conditions, the economy's response to even these strong policy initiatives will probably not be sufficient to yield a sustainable growth and balance of payments outcome in the program period. Nevertheless, the reform and adjustment measures provide a framework for more effective utilization of both domestic and external resources in support of structural and institutional changes which, once the security situation improves, can lead the economy to sustainable growth.

Proposed Decisions

The following draft decisions are proposed for adoption by the Executive Board:

i. Second Annual Arrangement under the SAF

1. The Government of Mozambique has requested the second 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 annual arrangement, and notes the updated policy framework paper (EBD/88/68).

3. The Fund approves the arrangement set forth in EBS/88/40.

ii. Exchange system

The Fund grants approval for the retention by Mozambique of the exchange restrictions evidenced by external payments arrears, and of the exchange restrictions remaining pending the execution of the rescheduling agreements with each individual creditor until December 31, 1988 or until the conclusion of the 1988 Article IV Consultation with Mozambique, whichever is earlier.

Structural Adjustment Facility:
Second Annual Arrangement

Attached hereto is a letter dated February 23, 1988 from the Minister of Finance of Mozambique, requesting from the Fund the second 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 second 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 second loan in the amount equivalent to SDR 18.3 million is available for disbursement at the request of Mozambique.

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

(a) the indicators specified in Tables 1 and 2 attached to the letter dated February 23, 1988.

(b) imposition of restrictions on payments and transfers for current international transactions,

(c) introduction of multiple currency practices,

(d) conclusion of bilateral payments agreements which are inconsistent with Article VIII,

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

3. In accordance with paragraph 18 of the letter dated February 23, 1988, 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 second annual arrangement.

4. In accordance with paragraph 18 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 deviations 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 23, 1988

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. The three-year SAF arrangement provided assistance that amounts to SDR 38.74 million, equivalent to 63.5 percent of quota, and a first annual loan under the arrangement equivalent to SDR 12.20 million, or 20 percent of quota. The ERP is aimed at reversing the long-term economic decline and correcting the large internal and external financial imbalances.

2. The implementation of the ERP is progressing largely as envisaged. Measures undertaken during 1987 included: substantial devaluations of the metical; sizable increases in controlled prices and an easing of price controls; implementation of tight demand management policies; a major reform of domestic taxation; a review of public enterprise operations; strengthening external debt management and the operation of the financial system; the negotiation of external debt relief; and an augmented flow of concessional financial assistance. As a result of these measures, and the substantial external assistance received in support of the ERP, the economic decline that characterized the past several years was reversed during 1987.

3. The financial targets for the 1987 program relating to the budget, domestic credit, and external borrowing, were largely attained, and quarterly benchmarks on total domestic credit expansion and net bank credit to the Government were also all observed.

4. In collaboration with Fund and World Bank staff, we have updated the policy framework paper to cover the period 1988-90. 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. The program assumes that the security situation remains essentially unchanged throughout the period and that appropriate inflows of concessional external assistance will be forthcoming in a timely manner. In the following paragraphs, this letter sets out certain more specific aspects

of objectives and policies underlying the program for 1988. In support of this program, the Government of the People's Republic of Mozambique requests a second annual arrangement under the SAF in an amount equivalent to SDR 18.3 million (or 30 percent of quota).

5. ERP policies during 1988 will continue to focus on the further reduction in economic distortions and financial imbalances and the relaxation of structural constraints on economic growth. The growth rate of GDP is projected to accelerate to about 6 percent and the average rate of price increase is expected to decelerate to about 70 percent, despite the continuing major adjustments in official prices. Success in efforts to accelerate the transfer of external resources on concessional terms in support of the program is reflected in a sizable increase in imports.

6. In support of these objectives, the Government intends to pursue vigorously the implementation of structural and macroeconomic policies outlined in the updated PFP. A central feature of macroeconomic policies will be the continued strengthening of public finances, including improvement in the financial position of public enterprises. With respect to government revenues, the major domestic tax reforms of 1987 are still being absorbed, but there is a pressing need for customs tariff reform, and efforts to improve yields of domestic taxes will continue. Consistent with the objective of strengthening domestic revenues, the Government is reviewing the recommendations of the IMF technical assistance mission with a view to preparing a revenue package of at least Mt. 10 billion during the first half of 1988, for implementation in the 1989 budget; however, we may advance the implementation of the revenue package if a revenue shortfall develops during 1988. We will also move quickly on preparation of the first-round tariff reform, essentially a major simplification, and its implementation by end-1988, thereby making feasible the use of selective and/or general surcharges for trade management or revenue purposes.

7. In order to achieve the target of Mt. 10 billion additional revenue referred to in paragraph 6 during 1988, we also intend to reduce by administrative action the exemptions from consumption taxes on imports and to reduce, in consultation with donors, the extensive exemptions from customs duties of aid-financed imports, as well as introduce various other administrative improvements in the customs service. All export duties are being eliminated in 1988, but the transactions tax will continue to apply to direct exports at a rate of 5 percent for revenue purposes. In addition, most remaining specific domestic taxes will be converted to an ad valorem basis in 1988, as originally planned for 1987.

8. With respect to budgetary outlays, a major element in containing current expenditure is the sharp reduction in consumer subsidies associated with the major increase in administered prices of rationed goods. To compensate partially for the reduction in subsidies on rationed goods, a wage supplement of about Mt. 4,000 per month per

worker will be introduced. These measures will be in place by the end of March. Budgetary outlays for consumer subsidies are expected to be reduced to about one half of the 1987 level of Mt. 6 billion. In addition, transfers to cover enterprise operating losses will be reduced to Mt. 12 billion in 1988. With respect to government interest payments, amounts actually due abroad are now being paid to the Bank of Mozambique, and the rate of interest on domestic debt, which is now being paid regularly, has been raised considerably. Total interest payments in 1988 are estimated at about Mt. 25 billion compared with Mt. 7.4 billion in 1987. As to the wage bill, the combined effect of the supplemental pay increase in January and the general wage increase anticipated for mid-1988 will be to increase the civil service wage bill in 1988 by less than the projected increase in the average price level of 70 percent. The general wage policy will be followed in the enterprise sector as well.

9. The capital budget will not be fully formulated and approved until February 1988. In its formulation the content of expenditures will be carefully scrutinized in terms of the return from completing ongoing projects and the contribution of new undertakings to rehabilitation and external earnings or savings. Given the estimated availability of external financing, it is expected that budgetary capital expenditures will increase somewhat in real terms in 1988. If the forecast level of aid is disbursed in a timely manner, it is unlikely that the ratio of the overall budget deficit (before grants) to total expenditure would decline in 1988. The increased value of external assistance foreseen as well as the more realistic valuation of food aid should generate sufficient resources to cover capital outlays and a portion of current expenditures. Accordingly, even with a nominal increase in the current account deficit to Mt. 35 billion on a cash basis, reflecting the substantial increase in interest payments, bank financing will be held to no more than Mt. 20 billion.

10. Credit policy during 1988 will be guided by the overall macroeconomic objectives of strengthening the balance of payments, reducing the rate of inflation and allocating a sufficient quantum of credit to the more productive sectors. The credit program would be based on a projected increase in money and quasi-money of about 43 percent. In pursuance of these objectives, the increase in domestic-source credit during 1988 (excluding credit to the economy arising from external concessional loans on-lent through the Bank of Mozambique) would be limited to Mt. 74 billion relative to its estimated level at the end of 1987, equivalent to 43 percent of the stock of the broad money at the beginning of the period; within this total, the increase in net credit to Government will be limited to Mt. 20 billion. Quarterly benchmarks have been established for both aggregate domestic-source bank credit expansion and the increase in net domestic credit to Government. The increase in aggregate bank credit will not exceed Mt. 29 billion by end-March 1988; Mt. 50 billion by end-June 1988; Mt. 65 billion by end-September 1988; and Mt. 74 billion by end-December 1988. Correspondingly, net credit to Government, which was estimated at

Mt. 57.9 billion at the end of 1987, will increase by no more than Mt. 10 billion by end-March, 1988; by no more than Mt. 15 billion by end-June 1988; by no more than Mt. 19 billion by end-September, 1988; and by no more than Mt. 20 billion by end-December 1988.

11. Greater emphasis will, during 1988, be placed on the prompt payment of interest charges to the banking system and other creditors by Government and the enterprise sector. In this regard, interest due but not paid is treated as credit under the foregoing benchmarks. This policy emphasis is essential not only in facilitating the restoration of financial discipline but also in supporting other reforms in the financial sector. In order to bring interest rates on government obligations to a more realistic level in relation to other rates, interest charged on the major part of outstanding loans to Government from the Bank of Mozambique was raised from 3 to 8 percent beginning in 1988. The structure of loan rates will also be simplified and reduced substantially from the present five categories by mid-1988.

12. In the external area, policies aimed at facilitating economic restructuring and strengthening the balance of payments will be continued. Exchange rate policies are aimed at attaining a realistic exchange rate by the end of the program period. Accordingly, there will be further exchange rate adjustments so that by mid-1988 the differential between the official and parallel market exchange rates will be substantially reduced. In the remainder of the year, the official exchange rate will be managed flexibly to at least avoid, on a monthly basis, a widening of the gap between the official and parallel market rates, without official sales in the latter market to influence the rate. The modalities for a more flexible exchange rate system will be jointly studied with the Fund staff in coming months and reviewed in the context of updating the PFP for 1989. This study will propose specific actions and a timetable for adaptations in the system. The Government is also implementing interim trade measures outlined in the PFP to reduce the scope of administrative control in the trade and exchange system.

13. Mozambique's gross international reserves increased by US$35 million in 1987, partly reflecting the disbursement late in the year of some concessional loans; the Bank of Mozambique will attain a level of reserves by the end of 1988 at least as high as that recorded at the end of 1987. The amount of external borrowing on nonconcessional terms of 1-12 years' maturity that the Bank or the Government may contract or guarantee will be limited to US$25 million, consistent with the need to alleviate Mozambique's heavy external debt burden. The Government will continue to approach external creditors to secure exceptional debt relief and concessional aid.

14. The overall balance of payments deficit is projected to increase by about US$45 million to around US$495 million in 1988, in part reflecting a decline in workers' remittances. This deficit, for which financing has largely been assured, should begin to decline in the years after

1988, although balance of payments viability would not be achieved during the program period. The required financing for 1988 will be met predominantly through some US$400 million in debt relief.

15. Structural policies for 1988 are spelled out in the updated PFP, and the benchmarks for monitoring structural policy implementation are shown in Table 1 and relate to:

(i) The implementation of the first stage of the tariff reform.

(ii) Formulation of a package of additional revenue measures.

(iii) Simplification of the structure of interest rates.

(iv) Increase in interest rate on bank credit to Government.

(v) Reduction in number of commodities subject to fixed prices.

(vi) Full pass-through of exchange rate changes to fixed-priced and "conditioned" commodities.

(vii) Substantial increases in administered prices of rationed goods.

(viii) Substantial reduction in the gap between the official and parallel market exchange rates.

(ix) Preparation and implementation of a list of imports subject only to routine and automatic licencing procedures.

(x) Flexible exchange rate management after June 1988 with adjustments as necessary to preclude widening of the differential between official and parallel market rate.

(xi) Limit on government subsidies to cover enterprise losses to no more than Mt. 12 billion during 1988.

16. The quantitative benchmarks for 1988 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 in the maturity range of 1-12 years. There is also an annual target for the level of gross international reserves.

17. 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 new external arrears, excluding debt service payments subject to rescheduling.

18. 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 1988, 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, and the PFP will be updated annually as the program is implemented. 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 1988 Program under the Structural Adjustment Facility

Policy measures	Time frame for measures
Budgetary Revenue Measures	
1. Implementation of the first stage of customs tariff reform.	By end-1988.
2. Formulation of a package of additional revenue measures.	By mid-1988.
Interest Rates	
3. Simplification of the structure of bank lending rates.	By June 1988.
4. Increase in the rate of interest on domestic bank loans to Government.	By January 1988.
External Policies	
5. Substantial reduction in the gap between the official and parallel-market exchange rates.	By June 1988.
6. Flexible exchange rate management with adjustment as necessary to avoid widening of gap between official and parallel-market rates.	After June 1988.
7. Preparation and implementation of a list of imports subject only to routine and automatic licensing procedures.	By end-July 1988.
Pricing and Distribution	
8. Substantial increases in administered prices of rationed goods.	By end-March 1988.
9. Reductions in number of products subject to fixed pricing.	January, end-June, and year-end 1988.

Table 1 (concluded). Mozambique: Benchmarks for Implementation of Structural Policy Measures for the 1988 Program under the Structural Adjustment Facility

Policy measures	Time frame for measures
10. Full price pass-through of exchange-rate effect on goods and services subject to fixed pricing and conditioned pricing.	Timing to match changes in official rate.
Public Enterprises	
11. Limitation of government subsidies to cover operating losses to no more than Mt. 12.0 billion.	1988.

Table 2. Mozambique: Quantitative Performance Benchmarks for 1988

	Outstanding Dec. 1987 (est.)	1988 Cumulative Quarterly Increase 1/ March	June	Sept.	Dec.	Out-standing end-1988
1. Aggregate bank credit 1/	221.2	29	50	65	74	295.1
2. Net bank credit to Government	57.9	10	15	19	20	77.9
3. Level of gross international reserves (US$ million)	107 (Sept.1988 actual US$98 million)	--	--	--	--	107
4. External borrowing on nonconcessional terms that the Government or the Bank of Mozambique may contract or guarantee (US$ million)	(Benchmark of US$20 million for 1987; estimated at US$14 million by end-1987)	--	--	--	25	--

Source: Data provided by the Bank of Mozambique and 1988 program targets.

1/ Changes indicated for domestic credit during 1988 exclude increases in credit to the economy on-lent from concessional external resources channelled through the Bank of Mozambique.

MOZAMBIQUE - Relations with the Fund
(As of January 31, 1988)

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 meticais:	SDR 61.0 million (100.0 percent of quota)
(c)	Fund credit (SAF):	SDR 12.2 million (20.0 percent of quota)
(d)	Reserve tranche position:	-- 1/

III. Current Arrangements and Special Facilities

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)

IV. SDR Department

(a)	Net cumulative allocation:	None
(b)	Holdings:	None

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: meticais) has been pegged to the U.S. dollar, the former peg to a weighted basket of six currencies having been suspended on that date. Fixed buying and selling rates for telegraphic transfers, in effect since January 1, 1988, have been Mt. 450 and Mt. 459, respectively, 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 third Article IV consultation discussions were held in Maputo during August 8-22, 1987.

Executive Board discussion of the staff reports (SM/87/245 and SM/87/256) took place on November 18, 1987, 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, Sections 2 and 3, and in concluding the 1987 Article XIV consultation with the People's Republic of Mozambique, in the light of the 1987 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/87/245, 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. In addition, exchange restrictions evidenced by external payments arrears are subject to approval under Article VIII, Section 2(a). The Fund welcomes the authorities' efforts under their present adjustment program toward the elimination of these restrictions, and at the same time urges the authorities to eliminate the restrictive features of the bilateral payments agreements that the People's Republic of Mozambique maintains with Fund members.

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

IX. SAF Arrangements: The Executive Board took the following decision on June 8, 1987:

1. The Government of the People's Republic of Mozambique has requested a three-year structural adjustment arrangement, and the first annual arrangement thereunder, under the Structural Adjustment Facility.

2. The Fund approves the arrangements set forth in EBS/87/101.

X. Technical Assistance

1. Statistics. An initial Bureau of Statistics mission in August 1985 assessed Mozambique's needs for technical

MOZAMBIQUE - Relations with the Fund (concluded)

assistance in statistics and provided a report on balance of payments methodology in December 1985. Technical assistance on compiling monetary statistics and developing a more suitable basic plan of accounts was provided to the Bank of Mozambique in early November 1985, and a report thereon was issued in February 1986. A subsequent joint Bureau of Statistics and Bureau of Computing Services mission in April-May 1986 followed up on these matters, provided training in the use of microcomputers to speed data compilation, and assessed the banking system's needs and plans for further computerization. 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 concurrently with the first two weeks of the August 1987 consultation mission, and its report was transmitted to the authorities at the end of December 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 and a third year. Since May 1986 an Accounting Advisor has been assigned to help revise the banking system's plans of 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. 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. Mozambican participants in Institute courses at Headquarters numbered 1 in 1985, 4 in 1986, and 4 in 1987.

4. 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. It provided the authorities with preliminary analyses and recommendations before departure and its report is expected to be transmitted in February 1988.

MOZAMBIQUE - Relations with the World Bank

The first World Bank economic mission to Mozambique took place in November 1984, and an Introductory Economic Survey was issued on June 6, 1985. 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; disbursements amounted to SDR 34.1 million by the end of 1987, leaving approximately SDR 11.4 million for disbursement in 1988. 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; about SDR 0.2 million was disbursed in 1987. 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; disbursements from these combined sources amounted to almost US$40 million in 1987.

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 credit for about SDR 10 million is 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 will initiate a Public Expenditure Review in April 1988, which will assess the efficiency pattern of recurrent expenditures and investments, and make appropriate recommendations. Technical assistance has also been initiated in external debt management and reporting.

Table 1. Mozambique: Selected Economic and Financial Indicators, 1984-90

Economic and financial indicators	1984	1985	1986	1987 Prog. 1/	1987 Est. Act.	1988 Prog.	1989 Projections	1990 Projections
	(Annual percentage changes, unless otherwise specified)							
Production and prices								
GDP at 1980 prices 2/	2.2	-10.4	2.0	1.2	3.8	5.9	4.7	4.5
GDP deflator 2/	22.0	51.0	15.6	...	139.7	63.1	30.0	20.0
Consumer prices	30.3	29.2	38.7	...	125.0 2/	70.0	30.0	15.0
External trade (based on US$ values)								
Exports, f.o.b.	-27.3	-19.9	3.2	8.9	8.6	22.2	22.0	22.0
Imports, c.i.f.	-15.2	-21.5	28.1	18.8	18.3	17.1	13.0	11.6
Terms of trade	15.2	5.0	13.5	-2.1	0.2	-0.7	0.8	1.4
Exchange rate								
Annual average (US$/Mt.)	-5.3	-1.7	6.8	-83.8	-86.1	-36.0 3/	...	...
Nominal effective 4/	17.8	7.3	-9.3	-90.8	-90.9	-40.0 3/	...	...
Government budget (cash basis)								
Revenue	-2.3	-15.2	13.8	297.6	216.7	76.0	45.8	28.5
Tax revenue	1.5	-15.6	14.7	389.4	275.0	82.5	47.3	29.7
Total expenditure	4.2	-11.6	30.5	258.2	221.4 5/	94.1	28.9	14.0
Current expenditure	-0.3	17.3	28.7	150.8	120.0 5/	66.3	29.0	12.5
Money and credit								
Domestic credit	20.7	16.1	17.1	23.7 6/	30.9	33.5 6/	...	...
Government (net)	64.1	21.4	21.7	76.0 7/	76.0 7/	34.5	...	...
Economy	14.1	14.9	16.1	11.0 6/	20.0 6/ 7/	33.1 6/	...	...
Money and quasi-money	15.4	15.4	15.5	44.6	48.7	43.0	...	...
	(In units stated)							
Overall balance of payments deficit (US$ millions)	355.7	353.4	488.0	458.7 8/	450.7	494.1	426.1	424.5
Gross foreign reserves (months of imports, c.i.f.)	1.7	1.2	1.5	1.6 8/	1.8	1.6	1.8	1.9
External debt (US$ millions)	2,388	2,794	3,157	3,560 8/	3,556	3,982	...	...
Of which: arrears	(454)	(589)	(711)	(--)	(--)	(--)	(...)	(...)
Debt service ratio 9/								
Before debt relief	195.9	215.4	247.4	237.7	271.0	239.7	192.3	178.5
After debt relief	96.2	110.4	247.4	45.3	45.1	57.5	61.1	63.4

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

1/ Percent changes from data used for program, i.e., revisions to 1986 data not reflected.
2/ Provisional staff estimates.
3/ Based on exchange rate as of January 1, 1988.
4/ December averages compared.
5/ Reflects inclusion of enterprise subsidies in expenditure data (estimated bank credit for 1984-86).
6/ Does not include foreign borrowing on-lent through domestic credit.
7/ Reflects shift of financing of enterprise losses from banks to budget in 1987.
8/ Adjusted for consistency in coverage with revised series shown.
9/ External debt service as percent of exports of goods and services (including workers' remittances).

Table 2. Mozambique: Social Indicators

	1973 1/	1986 1/	Reference low-income group
GDP per capita (U.S. dollars)	...	210 2/	260
Area (thousand sq. km.)	801.6	801.6	...
Percentage agricultural	58.7	58.7	...
Population			
Total population (millions)	10.1	14.2	...
Rate of growth (percent)	2.3	2.6	2.1
Urban (percent of total)	7.0	19.0	22.0
Population density (per sq. km.)			
Total land area	12.6	17.7	...
Agricultural area	21.5	30.1	349
Vital statistics			
Life expectancy at birth (years)	41	47	60
Infant mortality (percent)	16.7	12.3	7.2
Child (aged 1-4) death rate (percent)	2.8	2.2	0.9
Health and nutrition			
Population per physician (thousands)	62.1	50.7	8.9
Population per hospital bed (thousands)	1.0	1.2	1.1
Daily calorie supply per capita	1,981	1,617	2,339
Daily protein supply (grams) per capita	37	28	55
Access to safe water (percent of population)	10	9	...
Urban (percent of urban population)	62	82	...
Rural (percent of rural population)	2	2	...
Education			
Illiteracy rate (percent age 7+)	93	70	...
Primary school enrollment rate (percent)	87	83	97
Secondary school enrollment rate (percent)	3	6	32

Sources: National Directorate of Statistics, Informação Estatística; the World Bank (1987 Social Indicator Data Sheet); and staff estimates.

1/ Or nearest available date.
2/ As adjusted by World Bank staff for international comparability. Official GDP estimate and exchange rate yield US$292, unadjusted.

Table 3. Mozambique: Summary of Government Finance, 1984-88

	1984	1985	1986	1987		1988
				Program	Est. Act.	Program
			(In billions of meticais)			
Revenue	22.3	18.9	21.5	80.5	68.2	120.0
Tax revenue	16.2	13.7	15.7	73.9	58.8	107.3
Income and profits	(4.4)	(4.4)	(4.3)	(9.7)	(13.6)	(17.7)
Goods and services	(9.3)	(6.7)	(9.0)	(47.4)	(33.2)	(63.3)
International trade	(1.8)	(1.5)	(1.0)	(13.2)	(8.9)	(21.5)
Other taxes	(0.8)	(1.0)	(1.4)	(3.6)	(3.1)	(4.8)
Nontax revenue	6.1	5.3	5.9	6.6	9.4	12.7
Enterprise surpluses	(3.0)	(1.7)	(2.7)	(--)	(0.3)	(--)
Housing rents	(1.4)	(1.5)	(1.6)	(1.6)	(2.4)	(4.8)
Other nontax revenue	(1.7)	(2.1)	(1.5)	(5.0)	(6.7)	(7.9)
Current expenditure 1/	28.0	32.9	42.4	105.6	93.2	155.0
Total, budget year 2/	28.9	33.4	42.4	108.1	96.6	158.5
Defense and security	(10.3)	(11.0)	(12.4)	(42.4)	(42.6)	(62.7)
Other wages and salaries	(7.2)	(7.6)	(8.0)	(17.6)	(15.2)	(25.8)
Other goods and services	(4.0)	(4.3)	(5.0)	(14.4)	(12.0)	(21.5)
Interest 3/	(0.1)	(0.1)	(0.8)	(7.4)	(7.4)	(24.9)
Consumer subsidies	(0.4)	(0.5)	(0.5)	(6.8)	(5.8)	(3.5)
Enterprise subsidies 1/	(6.0)	(9.0)	(14.2)	(14.0)	(10.0)	(12.0)
Pensions and other	(0.9)	(0.9)	(1.3)	(5.5)	(3.6)	(8.1)
Complementary periods (net) 4/	-0.9	-0.5	--	-2.5	-3.4	-3.5
Current deficit	5.7	14.0	20.8	25.1	25.0	35.0
Capital expenditure	16.7	6.7	9.3	78.5	72.7	167.0
Total, budget year 2/	10.6	8.1	11.6	119.8	114.1	203.0
Complementary periods (net) 4/	6.1	-1.5	-2.3	-41.3	-41.4	-36.0
Total expenditure 1/	44.8	39.6	51.6	184.1	165.9	322.0
Overall deficit before grants 1/	22.5	20.6	30.1	103.6	97.7	202.0
Grants received	2.9	3.0	3.9	63.6	37.7	108.5
Overall deficit after grants 1/	19.6	17.6	26.2	40.0	60.0	93.5
External borrowing (net)	4.7	5.1	5.9	15.3	35.0	73.5
Disbursements	4.8	5.2	6.1	24.4 5/	44.0	86.5
Repayments	-0.1	-0.1	-0.2	-9.1 5/	-9.0	-13.0
Domestic bank financing (net) 1/	14.7	13.8	20.1	25.0	25.0	20.0
Other financing and discrepancy	0.1	-1.2	0.2	-0.3	--	--
Memorandum items (ratios):			(In percent)			
Current deficit/total revenue	25.7	74.1	96.7	31.2	36.7	29.2
Current deficit/overall deficit before grants	25.5	68.0	69.1	24.2	25.6	17.3
Overall deficit before grants/ total expenditure	50.2	52.2	58.3	56.3	58.9	62.7
Overall deficit after grants/ total expenditure	43.7	44.6	50.7	21.7	36.2	29.0
Domestic bank financing/total expenditure	32.8	34.8	39.0	13.6	15.1	6.2

Sources: Ministry of Finance; and staff estimates.

1/ Data for 1984-86 adjusted to include enterprise operating losses, which have been covered by budgetary subsidies since 1987 but were financed directly through bank credit prior thereto. Adjustments ("enterprise subsidies" for 1984-86) are authorities' estimates of such credit for 1985-86 and indicative staff estimate for 1984.

2/ Not adjusted for timing, i.e., includes complementary period spending after calendar year indicated.

3/ Includes domestic debt service for first time in 1987 (Mt. 2.3 billion then, and Mt. 6.0 million in 1988).

4/ Timing adjustments to offset net effects of complementary period spending.

5/ Revised to treat rescheduling as deduction from repayments rather than refinancing (addition to disbursements).

Table 4. Mozambique: Monetary and Credit Developments, 1984-87

	1984	1985	1986	1987 Program 1/	1987 Est. Act.	1988 Program
Balances, end of period			(In billions of meticais)			
Net foreign assets	1.0	0.6	0.4	9.7	20.0	31.5
Assets	4.0	2.9	3.5	39.9	50.2	...
Liabilities	-3.0	-2.3	-3.1	-30.2	-30.2	...
Domestic credit	124.2	144.2	168.9	208.9 2/	221.1	295.1
Credit to Government (net)	22.3	27.0	32.9	57.9	57.9	77.9
Credit to the economy	102.0	117.2	136.0	151.0 2/	163.2	217.2 2/
Foreign funds on-lent 3/	(27.2)	(34.2)	(36.8)	(36.8) 2/	(49.0)	(49.0) 2/
Domestic-source credit	(74.8)	82.9)	(99.2)	(114.2)	(114.2)	(168.2)
Money and quasi-money	83.6	96.5	111.4	161.2	171.6	245.4
Currency in circulation	27.0	29.8	32.2	42.0	35.0	50.0
Demand and savings deposits	53.8	62.8	75.1	115.1	126.6	182.2
Time deposits	2.8	3.9	4.1	4.1	10.0	13.2
Foreign borrowing	27.2	34.2	36.8	377.0	407.1	655.7
For domestic on-lending 3/	27.2	34.2	36.8	370.6 2/	400.8	...
SAF 4/ and other	--	--	--	6.4	6.3	...
Valuation adjustments	—	—	—	-329.8	-358.6	-594.9
Other items (net)	14.4	14.0	21.1	10.3	21.0	20.4
Capital accounts	11.6	12.7	14.4	...	14.7	14.7
Other assets and liabilities	2.8	1.3	6.7	...	6.3	5.7
Flows during year 5/						
Net foreign assets	2.6	-0.4	-0.2	5.3	29.3	--
Domestic credit	21.3	19.9	24.7	40.0	52.2	74.0
Credit to Government (net)	8.7	4.8	5.9	25.0	25.0	20.0
Credit to the economy	12.6	15.2	18.8	15.0 2/	27.2	54.0 2/
Foreign funds on-lent 3/	(1.5)	(7.0)	(2.6)	(...) 2/	(12.2)	(...) 2/
Domestic-source credit	(11.1)	(8.2)	(16.3)	(15.0)	(15.0)	(54.0)
Money and quasi-money	11.1	12.9	15.0	49.7	54.2	73.8
Foreign borrowing	1.5	7.0	2.6	6.4 4/	27.4	...
For domestic on-lending	1.5	7.0	2.0	--	24.3	...
SAF 4/ and other	--	--	--	6.4	3.1	...
Other items (net)	11.3	-0.4	7.0	-10.8	-0.1	-0.4
Rates of change 5/				(In percent)		
Domestic credit	20.7	16.1	17.1	23.7	30.9	33.5
Credit to Government (net)	64.1	21.4	21.7	76.0	76.0	34.5
Credit to the economy	14.1	14.9	16.1	11.0 2/	20.0	33.1 2/
Domestic-source credit 6/	12.4	8.0	13.9	11.0	11.0	33.1
Money and quasi-money	15.4	15.4	15.5	44.6	48.7	43.0

Sources: Bank of Mozambique; and staff estimates.

1/ Based on program flows and revised end-1986 stocks.
2/ Plus foreign funds borrowed and on-lent during year (see below).
3/ Amounts borrowed abroad by Bank of Mozambique on-lent domestically; excluded from program credit benchmarks.
4/ Reclassified from other items (net) in 1987 program presentation.
5/ Flows and resulting percent changes exclude valuation changes resulting from metical devaluations, mainly on external accounts but including Mt. 6.0 billion on foreign currency deposits.
6/ Change in relation to total credit to the economy.

Table 5. Mozambique: Balance of Payments, 1984–92

(In millions of U.S. dollars)

	1984	1985	1986	1987 Prog.	1987 Est.	1988	1989	1990	1991	1992
						Projections				
Trade balance	-444.0	-347.1	-463.6	-564.0	-556.1	-647	-722	-792	-866	-948
Exports (f.o.b.)	95.7	76.6	79.1	86.0	85.9	105	128	156	175	193
Imports (c.i.f.)	-539.7	-423.8	-542.7	-650.0	-642.0	-752	-850	-949	-1,042	-1,141
Services (net)	-32.1	-92.9	-158.7	-142.0 1/	-210.6	-248	-282	-272	-283	-283
Receipts	118.1	107.1	119.0	126.0	122.3	113	121	130	140	152
Transportation	34.5	39.4	45.0	58.0	31.3	41	48	55	64	73
Workers' remittances	57.0	40.8	50.0	43.0	55.0	30	30	30	30	30
Other service receipts	26.6	26.9	24.0	26.0	36.0	41	43	45	46	48
Expenditures	-150.2	-200.0	-277.7	-268.0 1/	-332.9	-361	-403	-402	-423	-435
Interest 2/	-80.9	-117.3	-154.7	-175.0	-195.3	-202	-239	-239	-255	-265
Other transportation	-24.5	-38.7	-34.0	-44.0	-35.0	-41	-43	-44	-46	-48
Workers' remittances	-25.7	-25.0	-23.0	-25.0	-22.8	-27	-29	-30	-31	-33
Investment services	...	...	-50.0	... 1/	-54.7	-55	-55	-50	-50	-47
Other service expenditure	-19.1	-19.0	-16.0	-24.0	-25.1	-36	-37	-39	-41	-42
Current account	-476.1	-440.1	-622.3	-706.0 1/	-766.6	-895	-1,004	-1,064	-1,149	-1,231
Unrequited official transfers	167.8	139.0	213.0	321.0	348.0	373	398	426	456	488
Capital account	-73.0	-39.7	-51.5	-19.0	-60.4	30	134	129	201	228
Foreign borrowing	264.8	238.8	284.0	310.0	308.6	350	375	401	429	459
Amortization	-337.8	-278.5	-335.5	-329.0	-369.0	-320	-241	-272	-228	-231
Grants and credits anticipated from new initiatives	—	—	—	—	—	—	45	85	120	150
Errors and omissions (net)	25.6	-12.7	-27.2	—	28.3	—	—	—	—	—
Overall balance	-355.7	-353.4	-488.0	-404.0 1/	-450.7	-492	-426	-425	-372	-366
Financing	355.7	353.4	488.0	404.0	450.7	492	426	424	372	366
Net foreign assets	-63.0	7.7	5.8	-19.0	-35.0	—	-25	-25	-25	-20
Assets (increase -)	-32.0	22.3	-19.0	-19.0	-35.0	—	-25	-25	-25	-20
Reserve assets	-23.0	20.5	-23.5	-19.0	-35.0	—	-25	-25	-25	-20
Bilateral payments	-1.4	2.3	4.9	...	—	—	—	—	—	—
Other	-7.7	-0.4	-0.4	...	—	—	—	—	—	—
Liabilities	-31.0	-14.6	24.8	—	—	—	—	—	—	—
Use of IMF credit (net)	—	—	—	15.0	15.4	25	11	—	—	—
Net change in arrears	205.6	152.7	482.2	...	-711.2	—	—	—	—	—
Additional financing	—	—	—	—	—	70	—	—	—	—
Exceptional financing	213.1	193.0	—	408.0	1,181.6	397	440	450	397	386
Debt relief 3/	213.1	193.0	—	408.0	1,181.6	397	...	...	...	...
Residual gap	—	—	—	—	—	—	440	450	397	386
Memorandum items:										
Gross international reserves	69.0	48.5	72.0	9.1	107.0	107	132	157	182	202
(in months of imports)	1.7	1.2	1.5	1.7	1.8	1.6	1.8	1.9	2.0	2.0
Actual debt service payments	—	50.1	8.0	...	93.9	125	152	181	208	255
Debt service ratio 4/										
Before debt relief	195.9	215.4	247.4	237.7	271.0	239	192	178	153	144
After debt relief	96.2	110.4	247.4	45.3	45.1	57	...	...	...	...
Current earnings/payments ratio 5/	35.1	36.4	29.8	28.5	26.7	23.9	24.6	25.7	26.1	26.3

Sources: Bank of Mozambique; and staff estimates.

1/ Does not reflect subsequent revision to include "investment services" payments (fees, profits, etc. financed from project loans).
2/ Includes imputed interest on arrears and interest on exceptional financing; for details, see Table 6.
3/ Reflects Paris Club and similar agreements in principle, not ultimate bilateral agreements. Reflects (1) October 1984 Paris Club agreement on approximately US$60 million in end-1983 arrears, US$153.1 million in 1984 maturities, and US$70.4 million in first half 1985 maturities; (2) OPEC member agreements in 1985 on US$96 million in arrears and US$26.6 million in 1985 maturities; (3) May 1987 London Club agreement on US$253.3 million (mainly arrears); (4) June 1987 Paris Club agreement on US$240.3 million for 1987 and US$120.4 million for 1988; and (5) other agreements on US$687.1 million for 1987 and US$276.9 million for 1988.
4/ As percentage of exports of goods and total service receipts.
5/ Ratio of current earnings from goods and services to current payments other than interest.

Table 6. Mozambique: Debt Service Projections on External Debt, 1985-95

(In millions of U.S. dollars)

	1985	1986	Est. 1987	Projections 1988	1989	1990	1991	1992	1993	1994	1995
Original debt service	352.8	447.6	521.7	421.6	350.2	352.9	297.7	263.0	216.7	185.7	104.2
Principal	278.5	335.5	369.0	320.7	240.5	272.1	228.1	208.7	173.4	151.5	75.9
Multilateral	(3.3)	(3.5)	(6.2)	(7.8)	(7.3)	(8.3)	(8.1)	(8.0)	(8.0)	(8.0)	(8.0)
Bilateral	(275.2)	(332.0)	(362.8)	(312.9)	(233.2)	(263.8)	(220.0)	(200.7)	(165.4)	(143.5)	(67.9)
Interest	74.3	112.1	152.7	100.9	109.7	80.8	69.6	54.3	43.3	34.2	28.3
Multilateral	(3.6)	(2.8)	(4.3)	(4.1)	(3.7)	(3.4)	(2.8)	(2.7)	2.5)	(2.3)	(2.1)
Bilateral	(70.7)	(109.3)	(148.4)	(96.8)	(106.0)	(77.4)	(66.8)	(51.6)	(40.7)	(31.9)	(26.2)
New debt service	43.1	42.6	42.6	101.2	129.1	158.3	185.5	233.4	278.2	289.0	306.4
Principal	--	--	--	--	--	--	--	22.5	44.9	44.9	34.4
On refinancing	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(22.5)	(44.9)	(44.9)	(34.4)
On new borrowing	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)
IMF repurchases	--	--	--	--	--	--	--	--	(3.1)	(8.1)	(10.4)
Interest	43.1	42.6	42.6	101.2	129.1	158.3	185.5	210.9	233.3	254.1	272.0
On refinancing 1/	(40.2)	(39.0)	(38.7)	(88.0)	(104.3)	(120.8)	(134.6)	(145.6)	(152.3)	(156.5)	(157.2)
On new borrowing	(2.9)	(3.6)	(3.9)	(13.1)	(24.6)	(37.2)	(50.6)	(65.0)	(80.7)	(97.4)	(114.6)
IMF charges	--	--	--	(0.1)	(0.2)	(0.3)	(0.3)	(0.3)	(0.3)	(0.2)	(0.2)
Total debt service	395.9	490.2	564.3	522.8	479.3	511.2	480.5	496.4	494.9	484.7	410.6
Principal	278.5	335.5	369.0	320.7	240.5	272.1	228.1	231.2	218.3	196.4	110.3
Interest	117.4	154.7	195.3	202.1	238.8	239.1	252.4	265.2	276.6	288.3	300.3

Sources: 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).

Table 7. Mozambique: External Financing Requirements and Availabilities, 1988-92

(In millions of U.S. dollars)

	1988	1989	1990	1991	1992
Financing requirements					
Current account deficit (before grants)	895	1,004	1,064	1,149	1,231
Amortizations	320	241	272	228	231
Reserve accumulation	--	25	25	25	20
Total	1,215	1,270	1,361	1,402	1,482
Available financing					
Grants	373	398	426	456	488
Anticipated new initiatives	--	45	85	120	150
Loans and credits (MLT)	350	375	401	429	459
Bilateral creditors	217	232	248	266	285
Multilateral creditors	133	142	152	163	174
IDA	102	129	116	148	116
Adjustment lending	80	70	40	50	50
Other IDA	22	59	76	98	66
Other multilateral	31	13	36	15	58
Fund disbursements	25	11	--	--	--
Additional financing	70	--	--	--	--
Debt relief	397	...	...	...	...
Total	1,215	830	911	1,005	1,096
Financing gap	--	440	450	397	386

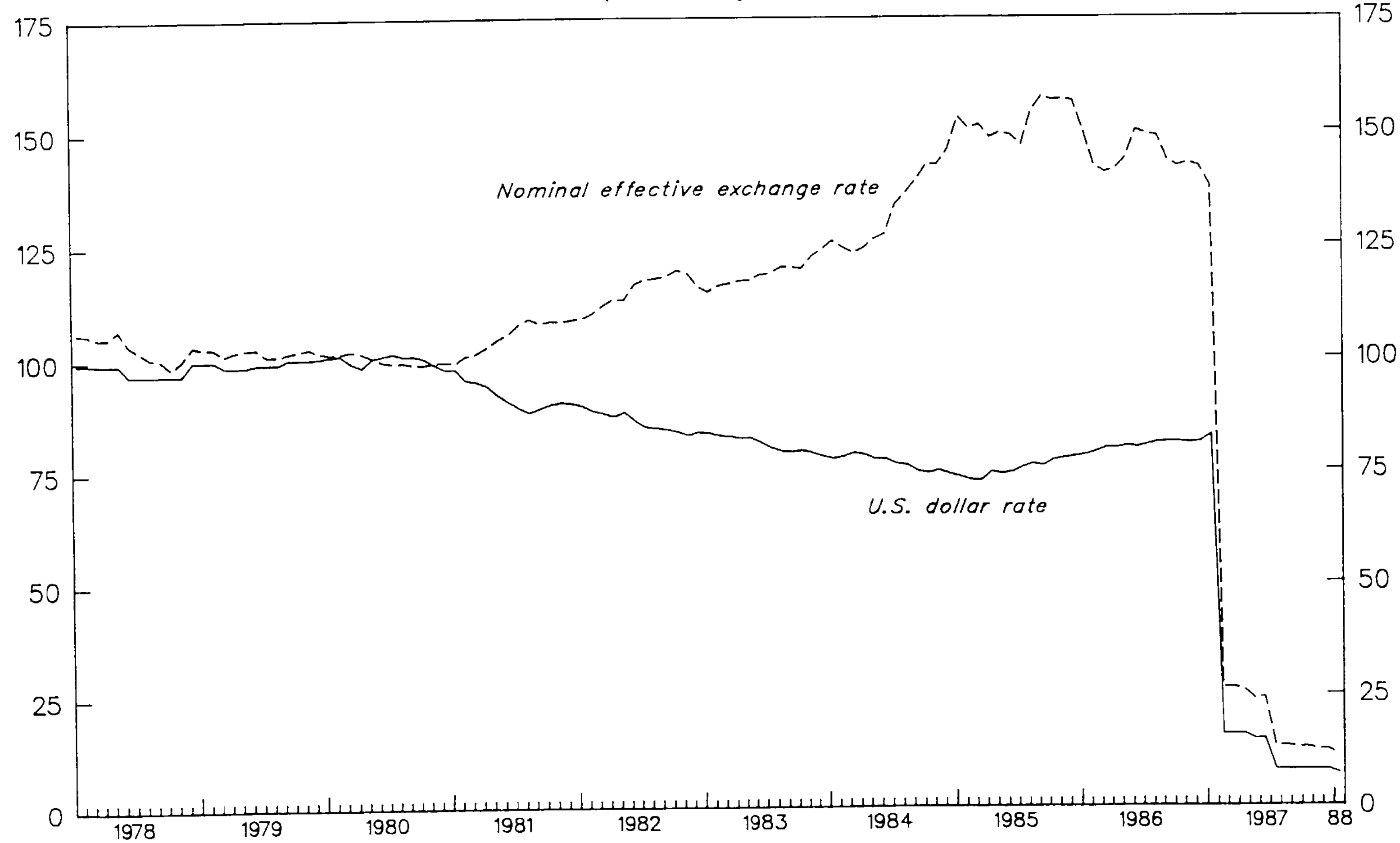
Sources: Bank of Mozambique; and staff estimates.

CHART 1

MOZAMBIQUE

EXCHANGE RATE DEVELOPMENTS, JAN. 1978–JAN. 1988

(Foreign currency per metical)
(Period average: 1980=100)



Sources: Bank of Mozambique; and staff estimates.

Table 8. Mozambique: Financial Benchmarks, Projections, and Performance, 1987-88

(Cumulative changes)

	1987				1988			
	Mar.	June	Sept.	Dec.	Mar.	June	Sept.	Dec.
	(In billions of meticais)							
Domestic credit 1/								
Program	13.0	26.0	36.0	40.0	29.0	50.0	65.0	74.0
Actual	3.2	9.6	26.2	40.0 2/				
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	25.0 2/				
Credit to the rest of the economy 1/								
Program	...	...	...	...	...	...	...	...
Actual	2.1	5.4	13.0	15.0 2/	...	...	...	...
Money and quasi-money								
Program				49.7				73.8
Actual				54.2 3/				...
	(In millions of U.S. dollars)							
Increase in gross international reserves								
Program	...	...	...	19.0	...	...	...	--
Actual	...	...	...	35.0	...	...	...	...
Noncessional external borrowing								
Program	...	...	...	20.0	...	...	...	25.0
Actual	...	...	...	14.0	...	...	...	...

Source: Bank of Mozambique.

1/ Excludes credit arising from foreign loans on-lent through the Bank of Mozambique.
2/ Estimated.
3/ Net of valuation increases in foreign-currency deposits (Mt. 6.0 billion).
4/ Contracting or guaranteeing by Government or Bank of Mozambique of nonconcessional external loans of 1-12 years' maturity.