FOR AGENDA

SM/86/259

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INFORMATION

October 21, 1986

To: Members of the Executive Board

From: The Secretary

Subject: People's Republic of Mozambique - Staff Report for the 1986 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with Mozambique, which will be brought to the agenda for discussion on a date to be announced. A draft decision appears on page 28.

Mr. Anjaria (ext. 8357) or Mr. Niebling (ext. 6943) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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CONTAINS CONFIDENTIAL INFORMATION

INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF MOZAMBIQUE

Staff Report for the 1986 Article IV Consultation

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 S. Kanesa-Thasan

October 20, 1986

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I. Introduction

The 1986 Article IV consultation discussions with Mozambique were held during July 5-28, 1986 in Maputo. The Mozambican representatives included Messrs. Abdul Magid Osman, Minister of Finance, and Eneas Comiche, Governor of the Bank of Mozambique, as well as Mr. Aranda da Silva, Minister of Internal and External Trade, Mr. João Ferreira, Minister of Agriculture, Mr. Antonio Branco, Minister of Industry and Energy, and Mr. Francisco Caravela, Secretary of State for Food and Light Industries. The mission chief was received by the Prime Minister, Mr. Mario da Graça Machungo. There was a governmental reorganization in July 1986, in which a new office of the Prime Minister was given primarily responsibility for economic policy and management. The staff team consisted of Messrs. Anjaria (Head-ETR) and Niebling (AFR), Ms. Mullor-Sebastian (RES), Messrs. Pinho (EP-AFR) and Kumah (EP-ETR), and Mrs. Ramos (Secretary-ETR). Mr. Mtei, Executive Director for Mozambique, visited Maputo during part of the mission's stay and attended some of the meetings.

Mozambique became a member of the Fund on September 24, 1984, with a quota of SDR 61 million. It avails itself of the transitional arrangements under Article XIV, Section 2, of the Fund's Articles of Agreement. The national currency is the metical (plural: meticais) and the exchange rate on June 30, 1986 was Mt. 40.6 = US$1. Mozambique has not drawn on Fund resources; details of the country's relations with the Fund are given in Appendix I. In response to the authorities' request for assistance in drawing up a financial program that could be supported by the use of Fund resources, a staff team had visited Maputo in November 1985; subsequently, the Article IV consultation discussions were combined with preliminary discussions on a possible Structural Adjustment Facility (SAF) program. The latter discussions are continuing.

The World Bank has accorded Mozambique an IDA rehabilitation credit of SDR 45.5 million, which is currently being disbursed. Visits of Bank program staff to Maputo have overlapped with both recent Fund missions, and collaboration remains close. Details of the Bank's activities are given in Appendix II.

II. Background

Upon Mozambique's independence from Portugal on June 25, 1975, the new Government inherited an economy in crisis. The economy had contracted sharply in the immediate pre-independence period, affected by the prolonged struggle for independence, the disruptions to economic activity arising from the Portuguese exodus, and the absence of adequately trained Mozambicans to replace them. To rebuild the economy, the authorities initially embarked on an accelerated development program, relying to a large extent on external resources and directed primarily toward capital-intensive agricultural production on state farms. The economy recovered somewhat in the first few years after independence. In the early 1980s, however, adverse exogenous developments including, in particular, intensified destabilization activities by political opponents and the second oil price increase, combined with inappropriate economic policies, contributed to a progressively more pronounced economic deterioration. Between 1981 and 1985, global social product (GSP, see below) declined by 37 percent in real terms, major domestic financial imbalances emerged, and the balance of payments came under severe pressure.

Mozambique has a centrally planned economy. Allocation of real and financial resources is made in the context of an annual plan prepared by the National Planning Commission. Plan targets and objectives are based largely on physical quantities, and, until recently, little provision had been made for the role of prices in decision making by economic agents. Given the commanding role of the state in setting production and distribution targets and directing economic activities, decisions to allocate credit or provide resources to the enterprise sector through the budget have not always received careful scrutiny to assess financial viability at the microeconomic level. At the macroeconomic level, little consideration has been given to overall resource availability and financial constraints. In the 1980s, economic activity has generally fallen substantially short of plan targets, while financial resources have been allocated on the assumption that physical targets would be achieved. Meanwhile, financial and budgetary controls have been weak. As a result, financial imbalances and distortions are widespread throughout the economy.

In April 1983, at the fourth congress of FRELIMO (Front for the Liberation of Mozambique, the country's only legal political party), a revised economic policy was called for to reduce the emphasis on state farms, and to promote private sector activity. Somewhat greater emphasis was to be placed on incentives to encourage productive activities. In the event, although some limited initiatives to liberalize prices and provide greater autonomy to enterprise managers were taken, the shift in approach proved difficult to implement quickly. On the political front, a regional accord, concluded in 1984 with a view to ending internal strife, bore little fruit. Thus, Mozambique's external and internal imbalances continued to worsen.

At the conclusion of the 1985 Article IV consultation in July 1985, Executive Directors expressed concern about the major financial imbalances and continuing economic contraction in Mozambique. They noted the extremely difficult internal and external circumstances confronting the authorities, particularly the impact of severe drought and the deteriorating security situation. While they shared the authorities' view that a cessation of the internal insecurity was an essential condition for a return to broad financial stability, they believed that fundamental changes in economic policy were required to arrest further economic and financial deterioration and to establish the preconditions for the resumption of growth on a sustainable basis.

Serious statistical deficiencies continue to inhibit analysis of economic and financial developments, but the authorities have intensified efforts to improve data collection and processing. Areas of improvement in the past year have included the revision of recent monetary and credit data and progress toward adopting a new plan of accounts, the preparation of a prototype consumer price index on an annual basis, and the revision of GDP expenditure estimates to reflect actual--rather than only official--transaction prices in private consumption. On the other hand, GDP is still estimated only in terms of expenditure and at current prices; the only measure of sectoral and overall production available is global social product (GSP), which measures the gross value of production in most sectors (at current and constant prices) but excludes "nonmaterial" services. Construction of a conventional, monthly consumer price index is planned. The investment and financing aspects of the fiscal accounts are uncertain, and data on the financial position of enterprises are weak or nonexistent. Major difficulties remain, moreover, in reconciling balance of payments, external debt, budgetary, and monetary data. The status of economic statistics in Mozambique is summarized in Appendix III.

III. Recent Economic Developments

The economic and financial situation of Mozambique has continued to deteriorate since the previous Article IV consultation in 1985. Real GSP declined in 1985 for the fourth consecutive year (Appendix IV), bringing real per capita GSP to less than three fifths of the level attained in 1981. Major declines have taken place in agriculture, industry, and transportation. The economic contraction is attributable to both exogenous factors and policy failures.

Agriculture accounts for one half of GSP and four fifths of employment. Seven primary products (cashews, cotton, tea, sugar, copra, sisal, and citrus) account for about one half of total exports. Much of the agricultural sector is organized into smallholder family farms, which account for 90 percent of the area under cultivation and most of the food crop production. In addition, there are some 40 state farms, which, although covering less than 5 percent of cultivated land, account for three fifths of the export crops produced. Following independence, state farms were established as management units to take over production on farms abandoned by the Portuguese. Since 1983, the Government has sought to promote the smallholder family sector, and there has been some distribution of land from state farms to private smallholders. Nevertheless, the bulk of resources is still directed to the state farms, which tend to rely more heavily on capital-intensive cultivation.

Between 1981 and 1985, adverse weather, transport problems, scarcity of agricultural inputs and incentive goods for producers, and unremunerative producer prices led to a one fifth reduction in agricultural production and an even sharper decline in marketed output. By 1985, output of cotton had declined to one tenth of its 1981 level, of cashews and sisal to one third, and of tea to one fourth. With growing food shortages, about 15 percent of the population was dependent on emergency food aid from abroad.

The collapse of export crops adversely affected industrial production, which relies considerably on imported inputs. Real GSP in the industrial sector was 57 percent lower in 1985 than in 1981. Capacity utilization had fallen to about 20-30 percent, owing to shortages of imported spare parts, raw materials, and capital goods, as well as the scarcity of domestically produced raw materials and inputs.

Activity in the transportation sector has declined sharply in the past decade, and particularly in the past five years. Historically, Mozambique's transport infrastructure was developed with a view to supplying transit facilities for goods to and from Malawi, South Africa, and Zimbabwe, but damage to infrastructure and lack of maintenance, as well as the diversion of South African transit trade to alternative ports, have had a negative effect on this sector. Activity in the construction sector, as well as in commerce, remained fairly stable during 1981-85.

Nominal GDP has risen rapidly in most recent years, reflecting the rapid growth in domestic liquidity and the emergence of parallel markets where goods are traded at several multiples of official prices. Some officially administered producer prices have been raised, mainly in 1985. Parallel markets for foreign currencies have also developed, with exchange rates at even higher multiples of the official rate. Private consumption in nominal terms doubled during 1981-85, while public consumption increased by only 50 percent; however, while private consumption is valued more nearly at actual prices, public consumption is accounted for mostly at official prices and is likely to be understated. Investment expenditure in recent years has consisted almost entirely of large public projects, including two dams and a textile factory that have been under construction for several years and are now nearing completion. Reportedly, practically no new investment is taking place in existing factories, owing to external financing constraints and the emphasis on rehabilitating existing plant and equipment. A sizable proportion of equipment is obsolete and breaks down often, driving up production costs.

Price data in Mozambique are incomplete, and provide an inadequate basis to form a judgment of inflationary trends. In 1986, for the first time, a consumer price index based on household expenditure surveys became available for the period 1981-85. The surveys were conducted once a year (in August, when prices may be at a seasonal low), and the price index resulting from the survey is intended to represent actual transactions, including purchases by households at both officially controlled prices and at parallel market prices. Owing to the weight of official prices in the index that is now available, the severe price distortions prevalent in the economy, and the declining availability of goods, the recorded changes in the price levels probably significantly understate the underlying rate of domestic inflation in Mozambique. The indices show an acceleration of inflation from 19 percent during 1982 to 29 percent in 1985. 1/ The authorities plan to construct a consumer price index based on standard methodology and periodicity from 1987 onward with external technical assistance.

Mozambique continues to operate a complex and extensive system of price controls, with prices falling into one of three categories: fixed, conditioned, or free. Prices for some 40 products are fixed at both the producer and the consumer level by the Council of Ministers or the National Commission on Salaries and Prices (CNSP). In practice, adjustments to fixed prices have been approved only infrequently (at intervals of 2-6 years). The vast majority of products are subject to conditioning, under which ex-factory prices are determined on production costs calculated by a formula established by the authorities, and subsequent sales are subject to observance of profit or commercialization margins specified in detail. In practice, ex-factory prices of products in this category have often remained fixed for prolonged periods, and adjustments have usually required prior approval. Finally, prices of a few products are officially free, mainly certain fruits, vegetables, and meats whose prices were deregulated in May 1985.

According to a recently completed IBRD-UNDP study of the energy sector, 2/ government policy is to control prices of energy products except woodfuels, and affordability for consumers is one of the criteria for determining prices. Economic costs are not explicitly considered. Official prices of some petroleum products and electricity are above import costs at the official exchange rate. Prices of kerosene, fuel oil, and domestically produced coal are below import costs. In urban areas, the controlled prices of petroleum products, electricity, and coal are only a small proportion (less than 25 percent) of the free market prices of woodfuels on an energy equivalent basis. The study recommends that the immediate pricing policy should include adjustments of prices of those products that are below import parity to import parity levels, and aim at ensuring full financial cost recovery. It also recommends an investigation of pricing mechanisms under which economic costs would be taken into account in price determination.

Wages have remained unchanged for several years. The wages of government employees were last raised in 1975, and the minimum wages of nongovernment workers were last increased in 1980 (by 50 percent). Nevertheless, the total wage bill grew by 28 percent between 1980 and 1985, reflecting increased employment in the public sector.

Enterprises in Mozambique fall into one of three categories, according to the degree of government control: state; "intervened,"

1/ August observations in each year.

2/ Mozambique: Issues and Options in the Energy Sector (IBRD and UNDP, June 1986).

i.e., state-controlled but privately owned; and private. The state and "intervened" enterprises (those abandoned by the Portuguese after independence and subsequently taken over by the Government) account for about two thirds of industrial production. The enterprise sector suffers from a lack of skilled workers and managers, poor accounting practices and financial records, and limited autonomy for managers to raise revenues or cut costs. Industrial enterprises are also heavily dependent on imported inputs, even agro-industries, which have suffered in recent years from the decline in agricultural production. Any profits of public enterprises are transferred to the Government, but in practice losses far exceed profits. While the state has taken responsibility in principle for covering the losses of public enterprises, so far it has done so almost entirely through the banking system directly, rather than through the budget. The extension of such credit has been virtually automatic.

The financial position of the Government itself has also worsened in recent years. The current budget, which has been adjusted to a cash basis, incorporates the financial operations of the Central Government and the provincial governments. The investment budget, issued at irregular intervals in recent years, also includes sizable investment outlays by state or "intervened" enterprises. For the past several years, Mozambique has recorded sizable overall budget deficits, climbing to Mt. 13.3 billion after grants (equivalent to 34 percent of total expenditure) in 1984 (Table 1). 1/ In 1985, the overall deficit declined to 28 percent of total expenditure because of a 60 percent decline in investment outlays. Indeed, the current budget balance shifted from a small surplus to a large deficit as total revenue declined by 15 percent, while current expenditure increased by 10 percent.

In 1986, according to preliminary estimates, the financial position of the Government is expected to show a severe deterioration, with the overall deficit rising to 41 percent of total expenditure. Several factors account for the deterioration. First, investment outlays in 1986 are expected to increase by more than 70 percent from the previous year, mainly reflecting heavy expenditure to complete two irrigation dams, a telecommunications project, a textile factory, and a gas exploration project. Second, current expenditure is projected to rise by over 11 percent. Third, total revenue is expected to stagnate; despite some tax increases, tax revenues are declining because of tax evasion and the shrinking of the tax base associated with the growth of parallel markets and the decline in production. With substantial year-to-year variations, roughly one half of the overall deficit (after grants) has been financed by bank credit in recent years, and the

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1/ The standard ratios of financial balances to GDP are not altogether meaningful in Mozambique, since price anomalies relatively understate official transactions. It should be noted, however, that the ratio used here may understate the rise in the overall deficit.

Table 1. Mozambique: Summary of the State Budget, 1981-86

(In billions of meticais)

	1981	1982	1983	1984	1985	1986 Budget	1986 Est.
Total revenue	18.9	25.7	22.9	22.3	18.9	19.5	18.6
Tax revenue	12.1	14.2	15.3	13.6	12.5	13.5	12.4
Taxes on income and profits	2.1	4.0	4.3	4.4	4.4	3.4	3.8
Taxes on goods and services	6.9	7.4	7.7	6.6	5.6	7.4	6.1
Taxes on international trade	2.5	2.1	2.4	1.8	1.5	1.5	1.5
Other taxes	0.6	0.7	0.8	0.8	1.0	1.2	1.0
Nontax revenue	6.8	11.5	7.6	8.7	6.4	6.0	6.1
Total expenditure	28.6	35.4	37.6	38.4	30.6	42.3	38.1
Current expenditure	16.7	19.9	22.5	21.7	23.9	27.6	26.7
Wages and salaries	5.8	6.5	7.2	7.2	7.4	8.7	8.3
Goods and services	4.4	4.7	4.5	4.0	4.3	5.0	4.5
Defense outlays	5.7	6.9	8.3	10.3	11.0	12.2	12.2
Other 1/	1.4	1.4	1.5	1.3	1.6	1.7	1.7
Adjustment 2/	-0.6	0.4	1.0	-1.1	-0.4	--	...
Investment expenditure 3/	11.9	15.5	15.1	16.7	6.7	14.7 4/	11.4 4/
Current surplus/deficit (-)	2.2	5.8	0.4	0.6	-5.0	-8.1	-8.1
Overall surplus/deficit (-) before grants, cash basis	-9.7	-9.7	-14.7	-16.1	-11.7	-22.8	-19.6
Grants	1.8	2.3	3.0	2.9	3.0	3.9	3.9
Overall surplus/deficit after grants, cash basis	-7.8	-7.4	-11.8	-13.3	-8.7	-18.9	-15.7
Financing	7.8	7.4	11.8	13.3	8.7	18.9	15.7
External (net)	4.7	5.4	6.9	4.7	5.0	...	7.6
Domestic banking system	4.7	-2.5	9.7	8.7	4.8	...	8.1
Other 5/	-1.5	4.4	-4.9	-0.2	-1.1	...	--

Sources: Data provided by the Ministry of Finance; the Bank of Mozambique; and staff estimates.

1/ Includes interest payments, subsidies, pensions, and miscellaneous provincial expenditures. Does not include losses incurred by public enterprises.
2/ Adjustment to offset net effects of complementary periods.
3/ Official figures adjusted to a cash basis.
4/ Excludes some public enterprise investment previously financed through budget.
5/ Residual item reflecting unidentified financing and discrepancies.

remainder by external borrowing. In 1986, the proportion financed internally may still slightly exceed 50 percent, notwithstanding an expected acceleration in drawings under external loans (equivalent to $190 million) to complete ongoing projects.

The data cited above underestimate the size of the underlying fiscal imbalance in several ways. First, the operational losses of the enterprise sector (estimated at Mt. 14 billion in 1986) have been covered by the banking system. Second, interest payments in the budget have been substantially underrecorded in recent years. Interest on the internal debt is not paid at all. Interest on the external debt is probably underrecorded, although no firm figures are available in the absence of a breakdown of external debt data by borrower. Third, in 1986 part of the investment outlays previously recorded in the budget (estimated at Mt. 4 billion) are being financed directly by bank credit to public enterprises. Fourth, foreign exchange expenditures are substantially undervalued in local currency terms at the official exchange rate. Finally, the use of official prices understates expenditure on domestic goods and services, although a small portion of essential outlays is now understood to take place at parallel market prices. No firm estimates are available of the size of the underlying fiscal imbalance.

The banking system that emerged from the nationalization and consolidation of the late 1970s is dominated by the Bank of Mozambique, which serves both as central bank and the largest commercial bank. The Bank of Mozambique has a monopoly of external transactions; it is banker to the Government, and provides over three fourths of the credit to the economy (the public enterprises and the private sector). The state-owned Banco Popular de Desenvolvimento accounts for most of the rest of the credit, mainly to agriculture, while a small foreign-owned private bank, the Banco Standard Totta, provides less than 3 percent. Public enterprises, both state-owned and "intervened," have been the major beneficiaries of bank lending, accounting for 87 percent of the outstanding credit to the economy at the end of 1985.

Monetary and credit developments during 1981-85 were characterized by a near trebling of domestic credit outstanding, by the decline of foreign reserves to very low levels, and by a substantial expansion of domestic liquidity despite the decline in output (Table 2). Of the Mt. 95 billion increase in domestic credit over the five-year period, some Mt. 25 billion was attributable to the Government's emergence as a major borrower from the banking system, but most of the rest reflected the virtually open-ended financing of enterprise losses as economic activity contracted. Some 87 percent of total claims on the economy outstanding at end-1985 represented loans past due, of which 38 percent was deemed suitable for rescheduling, 43 percent was considered appropriate for assumption by the Government as nonrepayment was attributed to factors exogenous to the enterprises, and 6 percent was to be written off. A considerable overhang of domestic liquidity was also built up in the early 1980s, with the ratio of money and quasi-money to marketed GDP

Table 2. Mozambique: Monetary and Credit Developments, 1981-86 1/

	1981	1982	1983	1984	1985	1986 Est.
Balances, end of year			(In billions of meticais)			
Net foreign assets	6.5	1.4	-1.7	1.0	0.6	0.6
Assets	7.4	2.8	2.5	4.0	2.9	2.9
Liabilities (short-term)	-0.9	-1.3	-4.1	-3.0	-2.3	-2.3
Domestic credit	62.3	73.0	102.9	124.2	144.2	177.8
Claims on Government, net	6.3	3.9	13.6	22.3	27.0	39.1 2/
Claims on the economy	56.0	69.1	89.3	102.0	117.2	138.7
Money and quasi-money	45.7	59.5	72.5	83.6	96.5	115.8
Currency outside banks	12.2	17.8	23.5	27.0	29.8	35.4
Demand and savings deposits	30.4	38.5	45.0	53.8	62.8	76.3
Time deposits	3.1	3.2	3.9	2.8	3.9	4.1
Foreign borrowing 3/	6.0	10.4	25.7	27.2	34.2	36.2
Other items, net	17.1	4.5	3.0	14.4	14.0	26.4
Changes during year			(In billions of meticais)			
Net foreign assets	-1.7	-5.0	-3.1	2.6	-0.4	--
Domestic credit	12.7	10.7	29.9	21.3	19.9	33.6
Claims on Government, net	4.7	-2.5	9.7	8.7	4.8	12.1 2/
Claims on the economy	8.1	13.2	20.2	12.6	15.2	21.5
Money and quasi-money	10.3	13.8	13.0	11.1	12.9	19.3
Foreign borrowing 3/	-0.6	4.4	15.3	1.5	7.0	2.0
Other items, net	1.3	-12.6	-1.5	11.3	-0.4	12.3
Rates of change			(In percent)			
Domestic credit	25.6	17.1	41.0	20.7	16.1	23.3
Claims on Government, net	278.2	-39.1	251.8	64.1	21.4	44.8
Claims on the economy	16.8	23.5	29.2	14.1	14.9	18.3
Money and quasi-money	29.3	30.3	21.9	15.4	15.4	20.0

Sources: Bank of Mozambique; and staff estimates.

1/ Data for 1980-83 are not strictly comparable with those for following years. Calculations based on less rounded data.

2/ Increase in 1986 differs from fiscal data by continuing to include some investments of enterprises no longer financed through the budget.

3/ Bank of Mozambique medium- and long-term foreign liabilities. Estimated and only approximate through 1984.

rising from 66 percent in 1980 to nearly 126 percent in 1983, a year of peak credit expansion and major economic decline. The growth of problem loans and excess liquidity led to some increased screening of credit requests beginning in 1984. Owing also to the lower level of activity and some reduction in government bank financing, domestic credit expansion slowed in 1984 and 1985. The growth of money and quasi-money slowed from over 20 percent in 1983 to about 15 percent a year in the following two years, probably also partly on account of a growing disuse of the national currency outside the public sector and an increase in barter transactions. The authorities have until now followed a policy of keeping low nominal interest rates, which are substantially negative in real terms. Deposit interest rates are currently 0-3 percent for time deposits of up to one year, and lending rates are typically 5-7 percent.

As a result of the sharp deterioration in the financial position of the Government expected in 1986, net claims on Government are projected to increase by 45 percent. 1/ Claims on the economy are anticipated to expand by 18 percent, mainly to cover enterprise losses estimated at Mt. 14 billion. The growth of money and quasi-money is expected to accelerate to some 20 percent, while little change is anticipated in the net foreign asset position of the banking system.

The chronically weak balance of payments situation of Mozambique has deteriorated dramatically over recent years (Table 3). Recorded trade flows have shrunk, foreign financing has declined, international reserves have been virtually exhausted, and debt service arrears are expected to climb to some $1.4 billion (or about seven times the total exports of goods and services) by the end of this year. In the late 1970s and early 1980s, a sharply rising import level was made possible mainly by heavy recourse to external borrowing, particularly for large projects. Subsequently, as receipts from merchandise exports and invisibles fell dramatically, imports had to be cut back. A sharp rise in the debt service burden contributed to the further deterioration in the balance of payments position. In October 1984, official creditors agreed, in the framework of the Paris Club, to provide debt relief on arrears accumulated as of June 30, 1984 as well as debt service payments (principal and interest) falling due between July 1, 1984 and June 30, 1985. By July 1986, three bilateral agreements (with Portugal, the United Kingdom, and the United States) under the Paris Club Agreed Minute remained to be concluded, and arrears had developed on payments due on the rescheduled debt to Paris Club creditors.

1/ As discussed below, in 1986 steps are being taken to shift responsibility for financing "productive" investments by enterprises from the state budget to the banking system, while absorbing the losses of enterprises into the budget. The 1986 credit estimates mentioned here reflect the earlier classification for the sake of comparability.

Table 3. Mozambique: Balance of Payments, 1981-86

(In millions of U.S. dollars)

	1981	1982	1983	1984	1985	1986 Est.
Trade balance	-520.3	-606.7	-504.8	-444.0	-347.2	-400.0
Exports (f.o.b.)	280.8	229.2	131.6	95.7	76.6	80.0
Imports (c.i.f.)	-801.1	-835.9	-636.4	-539.7	-423.8	-480.0
Services (net)	54.1	29.8	-0.5	-36.2	-78.8	-144.4
Receipts	171.1	165.2	160.0	114.0	107.1	124.6
Transportation	(82.0)	(83.4)	(66.4)	(34.5)	(39.4)	(50.0)
Workers' remittances	(64.5)	(61.7)	(71.9)	(53.0)	(40.8)	(47.6)
Other service receipts	(24.6)	(20.1)	(21.7)	(26.5)	(26.9)	(27.0)
Expenditures	-117.0	-135.4	-160.5	-150.2	-185.9	-269.0
Scheduled interest	(-35.9)	(-60.3)	(-88.2)	(-80.9)	(-103.2)	(-179.4)
Other transport	(-27.4)	(-28.3)	(-32.8)	(-24.5)	(-38.7)	(-41.0)
Workers' remittances	(-29.4)	(-23.5)	(-19.9)	(-25.7)	(-25.0)	(-28.6)
Other service expenditure	(-24.3)	(-23.3)	(-19.6)	(-19.1)	(-19.0)	(-20.0)
Current account	-466.2	-576.9	-505.3	-480.2	-426.0	-544.4
Unrequited official transfers	57.5	79.5	89.6	167.7	139.0	184.7
Capital account	409.0	395.3	42.8	-73.0	-39.7	-127.2
Foreign borrowing	718.2	724.6	339.3	264.8	228.8	240.0
Scheduled amortization	-309.2	-329.3	-296.5	-337.8	-278.5	-367.2
Short-term capital (net)	...	...	...	...	10.0	...
Errors and omissions (net)	-66.8	-40.8	44.3	23.2	-38.9	--
Overall balance	-66.5	-142.9	-328.6	-362.3	-365.6	-486.9
Financing	66.5	142.9	328.6	362.3	365.6	486.9
Net international reserves (increase -)	68.7	148.5	46.8	-54.2	16.9	--
Bilateral payments agreements	-2.2	-5.6	-3.4	-2.2	3.0	...
Debt relief 1/	--	--	--	213.1	193.0	...
Net change in arrears (increase +) 2/	--	--	285.2	205.6	152.7	486.9
Memorandum items:						
Stock of debt in arrears 3/	--	--	--	750.7	838.2	1325.1
Debt service payments (actual) 4/	...	...	...	...	36.0	59.7
Debt service ratio (after debt relief) 5/	76.4	98.8	131.9	98.0	102.7	267.2

Sources: Bank of Mozambique; and staff estimates.

1/ In 1984, the Paris Club rescheduled 1983 debt service in arrears, and 1984 current maturities of US$213.1 million and 1985 debt service of US$70.4 million. Debt relief shown for 1984 includes 1983 debt relief of approximately US$60 million, which is not shown separately. In 1985, members of OPEC also rescheduled 1983 and 1984 debt in arrears of US$96 million and 1985 debt service of US$26.6 million.

2/ Taking account of debt reschedulings in 1984-85.

3/ The stock of arrears shown at the end of 1984 is before debt rescheduling of 1984. In the absence of adequate information on debt service payments and valuation adjustments, data on stock of debt in arrears may not be fully consistent with net change in arrears.

4/ Preliminary estimates.

5/ Calculated as a percentage of exports of goods and total service receipts.

For trade flows, 1985 was the worst year since independence, as merchandise exports declined to $77 million, compared with a peak of $280 million in the early 1980s. The recent declines were mainly due to a contraction in recorded export volumes. Merchandise imports in 1985 fell to $424 million, a little over half the level of the early 1980s. The import contraction affected spare parts and equipment especially, while imports of consumer goods and raw materials also declined to some extent, despite substantial food aid. Current service receipts declined to a low of $107 million in 1985, as workers' remittances fell. Outflows on account of invisibles increased to $186 million, primarily because of the rise in scheduled interest payments and payments for transportation services. The decline in exports and the worsening of the services deficit, however, was more than equaled by the cutback in imports. As a result, the current account deficit (before grants) was reduced to $426 million.

Since 1983, the large current account imbalances have been financed primarily by a substantial buildup of external arrears and, to a degree, by still relatively sizable unrequited official transfers, mainly food aid and technical assistance. Net capital flows have turned negative since 1984. In 1985, the reduction in the current account deficit was reflected in the overall balance of payments deficit, which dropped to $366 million. The latter was financed in part by debt relief and a further reduction in net foreign assets, but mostly by a continued buildup of debt service arrears. At year-end, Mozambique's gross foreign assets amounted to $67 million (equivalent to about eight weeks of imports), but freely usable foreign exchange holdings were small, and net foreign assets were negligible. Consequently, debt service arrears have been piling up.

In 1985, the outstanding public and publicly guaranteed external debt (including arrears of over $0.8 billion) rose to $2.8 billion (or 16 times exports of goods and services). One half of the recorded increase in the external debt of about $500 million in 1985 came from new foreign borrowing, while the remainder came from valuation adjustments and data revisions. Of the outstanding stock of external debt, 40 percent was owed to OECD countries, about one third to centrally planned economies, and the rest to multilateral institutions and other countries, including the oil producing countries. Scheduled debt service rose to $382 million in 1985, equivalent to more than twice the level of exports of goods and services. 1/ After taking account of debt relief from the Paris Club and other creditors, the debt service ratio reached 155 percent in 1985. However, only about $36 million of debt service payments were actually made.

1/ In Mozambique, reference to goods and services, including factor services, in the denominator of the debt service ratio is considered appropriate, given the importance of remittances from Mozambican miners in South Africa.

In 1986, both exports and imports are believed to be recovering somewhat, but, given the delays in data reporting, these estimates should be treated cautiously. The increase in imports is expected to reflect mainly higher disbursements of foreign grants and credits, for which data are particularly weak. As a result of higher interest payments falling due, the net balance on the services account is expected to deteriorate sharply. The current account deficit is projected to rise to $544 million, or almost the record level of 1982, when total trade flows (exports plus imports) were 90 percent higher. A sharp deterioration in the capital account balance is also expected, owing to a jump in scheduled amortization payments. As a result, the overall balance of payments deficit in 1986 may reach $487 million (more than twice the exports of goods and services, and 65 percent of imports of goods and services). The overall deficit is expected to be financed entirely by a further accumulation of external arrears, and total outstanding external debt (including arrears) is projected to rise by about 10 percent to some $3.2 billion by the end of the current year.

The metical is pegged to a weighted basket of six currencies representing most of the country's external transactions. The exchange rate against the U.S. dollar, the intervention currency, and the corresponding rates for 20 other currencies are set and published daily on the basis of market quotations abroad. The official average exchange rate for 1985 was Mt. 43.18 = US$1. From 1981 to 1985, the nominal effective rate of the metical appreciated by 38 percent, although the metical depreciated by 17 percent against the U.S. dollar (see Chart). 1/ Parallel market rates of Mt. 1,200-1,500 per US$1 have been reported in Maputo in the past few years, although the parallel market exchange rate of Mt. 600 per US$1 has been reported outside the main urban areas.

Mozambique maintains a comprehensive system of restrictions on trade and on payments and transfers for current international transactions. All imports and exports are subject to licensing. Import licenses are granted according to the guidelines of the central state plan. Imports

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1/ Developments in the nominal effective exchange rate for the metical, and the continued high rate of inflation in Mozambique, suggest that the real effective exchange rate for the metical probably appreciated by more than 10 percent since the most recent Executive Board discussion of exchange rate developments and policy in Mozambique--the July 1985 discussion of the previous Article IV consultation report. The metical has appreciated by 2.6 percent in nominal effective terms since July 1985, based on the standard index developed in connection with the information notice system. Available official information on inflation suggests that the rate of inflation in Mozambique between July 1985 and June 1986 exceeded that in trading partner countries by more than 20 percent, thus resulting in a substantial real appreciation. Since recent developments in the exchange rate and exchange rate policy are discussed in the present paper, no separate information notice will be issued.

of raw materials, spare parts, petroleum, food, and medicines are given priority. Until 1984, most imports could be undertaken only by state trading enterprises. However, under a new foreign exchange administration system introduced in May 1984, five funds have been established--the export retention fund, the freight fund, the petroleum fund, a fund for specific projects, and the general exchange fund--to allocate foreign exchange receipts. Many enterprises in the exporting business retain access to a variable percentage of their foreign exchange earnings under the export retention fund for their purchases of imported inputs. Some firms are authorized to import directly. The system of retention of export proceeds is aimed at decentralizing exporting and importing activities to designated industries and establishments, both private and public. All major export industries and foreign exchange shops benefit from this scheme, but all other foreign exchange receipts from exports of goods and services must be surrendered to the Bank of Mozambique. A premium exchange rate for remittances from Mozambican miners in South Africa was eliminated in March 1986. Mozambique has maintained a bilateral agreement with Tanzania which predates its membership in the Fund, and other bilateral agreements (see below) which may contain bilateral payments features exist between Mozambique and other Fund members and nonmembers.

IV. Report on the Discussions

The discussions with the authorities focused on the importance, which the authorities fully acknowledge, of reducing the external and internal imbalances, and on the specific measures needed and their timing and extent. Discussions with the staff on these issues are continuing. The authorities hope that the adjustment measures that Mozambique is prepared to undertake will receive considerable technical and financial support (the latter on highly concessional terms) from the multilateral agencies and bilateral donors and creditors to sustain the reforms envisaged.

During the discussions, the authorities put forward the outlines of an Economic Rehabilitation Program for 1987-89, which provides a framework for policy reforms to be phased in over the next few years. The objectives of the program are to increase production in the agricultural sector; to revive transport activity, particularly international railway and port traffic; to increase industrial capacity utilization and production for export, including fisheries and mineral resources; and to rehabilitate the physical infrastructure and industrial capacity, particularly where these are designed to support directly productive activities. To these ends, the authorities plan to implement a program of structural adjustment and financial management, whose main elements include (1) a major initial exchange rate adjustment, to be made early in 1987, followed by a flexible exchange rate policy; (2) adjustment of administered prices and introduction of greater flexibility in price formation; (3) some layoffs of redundant workers, coupled with some salary increases, in public administration and enterprises, with bonuses

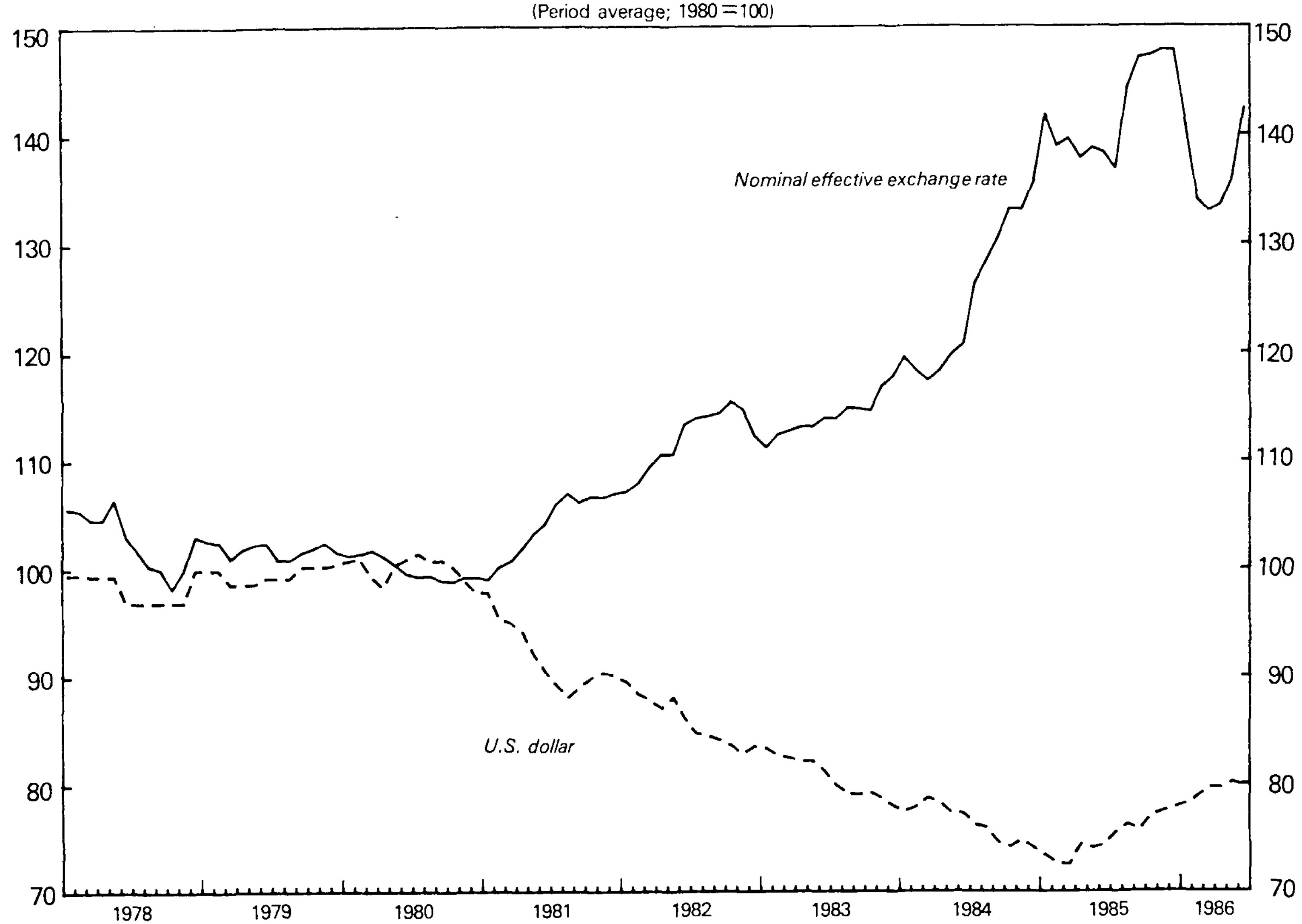
CHART

MOZAMBIQUE

EXCHANGE RATE DEVELOPMENTS, JAN 1978-JUNE 1986

(Foreign currency per metical)

(Period average; 1980 = 100)



Sources: Bank of Mozambique; and staff estimates.

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allowed in profitable firms; (4) a reduction in the current budget deficit (measured at 1986 prices and exchange rate and excluding debt service and transfers to enterprises) and the adoption of a target of a balanced current budget over the medium term; (5) elimination of enterprises' net operating deficits over the medium term, beginning with a reduction of one third (also measured at constant 1986 prices and exchange rate) in 1987, and other measures to increase enterprise profitability; and (6) a tight policy of control over credit expansion. The Mozambican representatives considered that Fund approval of a SAF program should lead to a further rescheduling of the country's external debt, which they intend to request.

The authorities believe that it will be important to introduce policy changes in a coordinated, rather than a piecemeal, fashion. They also believe that neither the importance nor the difficulty of such a large-scale change in policy approach should be underestimated. Accordingly, the authorities have concluded that, notwithstanding the urgency of reforms, the most important policy actions require further administrative preparations. They stated that they are ready to announce some price adjustments and interest rate increases before the end of 1986, but they acknowledged that further work on the other main elements of a three-year program is needed.

For the first time, the discussions with the Mozambican representatives also covered the medium-term balance of payments outlook on the basis of alternative scenarios. Both the staff and the Mozambican authorities felt that, despite the weak statistical base, medium-term projections would serve to highlight the size of the balance of payments problem. One such scenario prepared by the staff is shown in Table 4. Exports are assumed to reverse their sharply downward trend of the past five years and to grow moderately in volume terms. It is hypothesized that the volume of cashew exports will grow by 15 percent annually during 1987-91, reflecting the recent revival of this sector. Most other export volumes are assumed to grow by 10 percent; however, prawn export volumes are assumed to remain unchanged, as a biological limit has been reached on catches. Export prices are based on Fund commodity price projections, where available, or on assumed world inflation of 5 percent a year. Imports are assumed to be constrained to a level that can be financed from estimated foreign exchange resources projected to be available following further debt relief on current maturities and on debt service payments past due, and assuming no accumulation of new arrears. External grants and foreign borrowing are assumed to change little from the levels of recent years. Even with the constrained level of imports, the remaining financing gap is assumed to rise until 1989 before declining gradually in subsequent years in line with a gradual improvement in the external accounts.

The scenario demonstrates the extent to which for the foreseeable future the balance of payments will continue to be dominated by the heavy debt service burden. Through 1988, originally scheduled debt service payments only on debts contracted until end-1985 exceed assumed exports

Table 4. Mozambique: Balance of Payments Projections, 1986-91

(In millions of U.S. dollars)

	1986 Est.	1987	1988	1989	1990	1991
Current account	-544.4	-489.6	-482.4	-467.7	-417.8	-417.0
Trade balance	-400.0	-345.0	-335.0	-325.0	-310.0	-300.0
Exports	(80.0)	(95.0)	(105.0)	(115.0)	(130.0)	(150.0)
Imports	(-480.0)	(-440.0)	(-440.0)	(-440.0)	(-440.0)	(-450.0)
Scheduled interest 1/	-179.4	-195.6	-198.4	-210.7	-217.8	-227.0
Other services, net	35.0	51.0	51.0	68.0	110.0	110.0
Receipts	(124.6)	(121.0)	(121.0)	(138.0)	(180.0)	(180.0)
Expenditures	(-89.6)	(-70.0)	(-70.0)	(-70.0)	(-70.0)	(-70.0)
Unrequited transfers	184.7	150.0	150.0	150.0	150.0	150.0
Capital account	-127.2	-130.2	-95.6	-2.3	-7.1	-8.5
Foreign borrowing	240.0	200.0	200.0	200.0	200.0	200.0
Scheduled amortization 2/	-367.2	-330.2	-295.6	-202.3	-207.1	-208.5
Short-term capital	--	--	--	--	--	--
Errors and omissions (net)	--	--	--	--	--	--
Overall balance	-486.9	-469.8	-428.0	-319.9	-274.9	-275.5
Financing	486.9	469.8	428.0	319.9	274.9	275.5
Net international reserves (increase -)	--	-15.0	-10.0	-15.0	-15.0	-15.0
Bilateral payments agreements	--	--	--	--	--	--
Debt relief 4/	--	1,732.9	321.4	207.5	197.5	197.5
Current maturities	(--)	(407.8)	(321.4)	(207.5)	(197.5)	(197.5)
Arrears rescheduled	(--)	(1,325.1)	(--)	(--)	(--)	(--)
Variation in arrears	486.9	-1,325.1	--	--	--	--
New arrears	(486.9)	(--)	(--)	(--)	(--)	(--)
Arrears reduced	(--)	(-1,325.1)	(--)	(--)	(--)	(--)
Remaining financing gap	--	77.0	116.6	127.4	92.4	93.0
Memorandum items:						
Stock of debt in arrears	1,325.1	--	--	--	--	--
Debt service ratio 3/						
Before debt relief	267.2	243.4	218.6	163.2	137.1	132.0
After debt relief 4/	267.2	54.6	76.4	81.2	73.4	72.1

Sources: Bank of Mozambique; and staff projections.

1/ Scheduled interest includes original scheduled interest (modified by debt relief obtained in 1984-85), imputed interest on arrears, moratorium interest on debt relief, and assumed interest on new borrowing.
2/ Originally scheduled amortization plus principal repayments in accordance with assumed debt relief terms.
3/ Calculated as a percentage of exports of goods and total service receipts.
4/ Assumes debt relief on 1987-91 maturities on the same terms as those agreed in 1984 and 1985 by Paris Club and other creditors.

of goods and service receipts by a substantial margin (with the debt service ratio reaching almost 1 1/2 times current earnings in 1988). With no new external borrowing, the debt service ratio drops to 85 percent in 1989, and to 62 percent in 1991. Taking into account new external borrowing as assumed in Table 5, and on the assumptions that Paris Club and other creditors provide further debt relief in each year of the projection on terms similar to those obtained in 1984-85, and that accumulated debt service arrears are rescheduled in 1987, the debt service ratio is projected to rise from 55 percent in 1987 to 81 percent in 1989, before dropping to 72 percent by 1991. Even this projection could not be realized in the absence of significant structural changes in the economy: if exports are to grow despite the assumption under this scenario of a further decline in imports from present low levels, exchange rate and pricing policies should be such as to increase the efficiency of resource use and induce a shift in the composition of imports in favor of export-oriented production.

The Mozambican representatives stated that it would be a major mistake to underestimate Mozambique's import requirements for rehabilitation and recovery, especially given the high dependence of productive activity on imports and their present low level compared with just 4-5 years ago. A preliminary scenario prepared in line with the broad views of the authorities is summarized in Table 5 as Scenario B. The main differences from the initial scenario (reproduced as Scenario A) relate to the level of imports and the external financing assumptions. Scenario B is based on the assumption that a level of merchandise imports of $2.6 billion over 1987-90 represents the minimum requirement to ensure the success of the rehabilitation effort, and on more optimistic assumptions about growth in export volume. In this case, gross external concessionary assistance totaling $2.5 billion would need to be mobilized over the next four years, compared with external financing of $1.6 billion over the period 1983-86. 1/ Scenario A would imply corresponding external financing requirements some $700 million lower than in Scenario B in the next four years. Under both scenarios, Mozambique's debt service payments (after debt relief) are projected at about $150 million more per year than actual debt service payments in the past four years.

It is clearly premature to reach firm judgments on the likely balance of payments evolution over the medium term, since the adjustment policies to be adopted have not been fully worked out. Both scenarios indicate that balance of payments viability will be difficult to achieve in Mozambique in the foreseeable future. In particular, the burden of the existing external debt in the context of currently low export and invisible receipts is clearly such that an exceptionally strong

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1/ The external financing requirements cited include the total of unrequited transfers, gross external borrowing, and other exceptional financing.

Table 5. Mozambique: Medium-Term Balance of Payments Scenarios, 1987-90

(In millions of U.S. dollars)

	Four-Year Cumulated Totals		
	1983-86	1987-90	
	Actuals	Scenario A 1/	Scenario B 2/
A. Sources of foreign exchange	2,198	2,539	3,391
Exports	384	445	652
Services, (net)	192	280	280
Unrequited transfers	581	600	1,000
Foreign borrowing	1,041 3/	800	960
Exceptional financing	--	414	499
B. Uses of foreign exchange	2,198	2,539	3,391
Imports	2,080	1,760	2,590
Actual debt service	105 4/	724	746
Accumulation of reserves	13	55	55
Memorandum items:			
Debt service before debt relief	1,736	1,893	1,915
Debt relief	310	1,134 5/	1,134 5/
Accumulation of arrears	1,321	--	--

Sources: Bank of Mozambique; and staff estimates.

1/ Staff projections from Table 4.
2/ Based on scenario prepared by the Mozambican authorities, adjusted to ensure methodological comparability, especially for debt service payments.
3/ Includes net errors and omissions.
4/ Staff estimate.
5/ Assuming debt relief during 1987-90 on terms similar to those provided in 1984-85 by Paris Club and other creditors.

adjustment effort, coupled with considerable external financing, will be required to re-establish the basis for economic recovery and orderly relations with creditors. 1/

The specific issues discussed covered the range of proposals set out in the authorities' policy document, which were elaborated on in the discussions. Clearly, exchange rate and pricing policies will be the centerpiece of the adjustment and recovery effort. As regards exchange rate policy, after a sharp initial adjustment, a flexible exchange rate arrangement involving periodic (e.g., quarterly) discrete devaluations would be adopted. One objective of the exchange rate flexibility should be to eliminate a substantial portion of the gap with the parallel market exchange rate within a reasonable period; adoption of tight financial policies should help to bring about the narrowing of the gap. More broadly, the establishment and maintenance of a more realistic exchange rate should eventually pave the way for a relaxation of the pervasive exchange and trade controls, and encourage greater flexibility in the organization of the foreign trade and domestic commercialization system over the longer run.

As regards pricing policies, the authorities intend to allow flexibility in price formation so that producers and traders can vary prices in the light of cost developments and subject to established profit margins. In particular, the authorities intend to shift certain products from the fixed price list to the conditioned list and, at the producer level, to simplify the procedures for price adjustment and eliminate the present requirement of prior approval for changes in conditioned prices. In order to encourage production for export, the authorities plan to raise many export producer prices to the extent of the initial depreciation of the exchange rate, while other prices will be allowed to reflect the higher cost of imports. An important element of the price policy will be the adjustment of prices of key enterprises to levels that cover costs and thus reduce their operating losses. Significant adjustments are also planned in the prices of hydrocarbons, rents, and transportation and other services. Notwithstanding the general move toward greater price flexibility, the authorities plan to subsidize five staple commodities through the budget, and to raise their prices in the two main urban centers--Maputo and Beira--by considerably less than the average. Some of these five commodities are among those currently being rationed in Maputo; beginning next year, the rationing will be extended to Beira.

The authorities are firmly of the view that prudent and more flexible wage and labor market policies should constitute an important element of the recovery program. Following the exchange rate and widespread price adjustments, some salary increases in enterprises and the public administration are considered essential, particularly since wages in the latter have not been raised since 1975. A new labor law enacted

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1/ Table 6 provides projections of debt service payments.

Table 6. Mozambique: Debt Service Projections on External Debt, 1986-91

(In millions of U.S. dollars)

	1986	1987	1988	1989	1990	1991
Original debt service 1/	481.9	416.7	330.9	216.0	205.6	205.6
Principal	367.2	330.2	277.5	174.6	173.0	173.0
Multilateral	(4.0)	(6.7)	(7.6)	(6.8)	(6.6)	(6.6)
Bilateral	(363.2)	(323.5)	(269.9)	(167.8)	(166.4)	(166.4)
Interest	114.7	86.5	53.4	41.4	32.6	32.6
Multilateral	(2.0)	(2.2)	(1.9)	(1.7)	(1.5)	(1.5)
Bilateral	(112.7)	(84.3)	(51.5)	(39.7)	(31.1)	(31.1)
New debt service 2/	64.7	109.1	163.1	197.0	219.3	229.9
Principal	--	--	18.1	27.7	34.1	35.5
Interest	64.7	109.1	145.0	169.3	185.2	194.4
Total debt service	546.6	525.8	494.0	413.0	424.9	435.5
Principal	367.2	330.2	295.6	202.3	207.1	208.5
Interest	179.4	195.6	198.4	210.7	217.8	227.0
Debt service after debt relief 3/	546.6	118.0	172.6	205.5	227.4	238.0
Debt service ratio after debt relief 4/	267.2	54.6	76.4	81.2	73.4	72.1

Sources: Bank of Mozambique; and staff estimates.

1/ Revised debt service projections prepared by the authorities on external debt outstanding as of December 31, 1985.

2/ Includes estimated debt service on arrears at the end of 1985 and projected arrears for 1986, on assumed debt relief, and on exceptional financing and new borrowing from 1985 to 1991.

3/ Assumes debt relief during 1987-90 on terms similar to those agreed with Paris Club and other creditors in 1984-85.

4/ Calculated as a percentage of exports of goods and services.

at the end of 1985 established the terms and conditions of the contractual relationship between employer and employee for the first time since independence. When implemented, this legislation should provide enterprises with a greater degree of flexibility in hiring and laying off workers. A notable feature of the new law is the provision that workers can be laid off if employers determine that labor shedding is required under certain conditions. In addition, profitable enterprises are to be given flexibility to offer bonuses and premia to reward productivity.

It is evident that, under any medium-term scenario, a sharp reduction in the fiscal imbalance will be required. The specific measures to achieve this goal are still being developed. However, the authorities plan to introduce important changes at the outset in allocating responsibility between the Government and the public enterprises for financing the latter's rehabilitation and investment effort. Until now, most investment expenditure by public enterprises has been included in the investment budget prepared on the basis of the investment program in the Plan, while public enterprises' operating losses were financed by the banking system. The authorities consider that the Bank of Mozambique should finance only viable investment outlays by enterprises in the future, while enterprise operating losses should be covered by the budget. The transfer of enterprise deficits to the budget is viewed as a means of effecting better financial control over loss-making enterprises.

As regards current revenue and expenditure, the authorities believe that the scope for expenditure cutbacks is limited in the short run, since defense expenditure is estimated to account for 46 percent of current expenditure in 1986. Total wage payments can be brought under better control, for example, by controlling the number of civil servants and laying off unproductive and less skilled public employees. At the same time, reasonable wage increases will be necessary to protect, albeit partially, the incomes of low-income workers after the price and exchange rate adjustments, and to provide incentives for relatively poorly paid skilled public officials to remain in the administration. Expenditures on goods and services, excluding defense, have in fact risen only moderately in nominal terms, and may need to rise following the price and exchange rate adjustments, as a significant share of this expenditure is in foreign currency. The authorities therefore consider that actions to improve public finances should concentrate on raising revenue. Apart from raising taxes, the main avenues for doing so are to restore economic activity and the tax base, improve tax administration, and reduce tax evasion. The restoration of the tax base will be greatly facilitated by pricing measures that reduce the extent of parallel markets. To illustrate, with an essentially unchanged tax structure, the ratio of tax revenue to estimated GDP declined from 15 percent in 1980 to just under 7 percent in 1986. This suggests that there maybe considerable scope for increased tax collections following substantial price corrections and absorption of parallel markets. The authorities are in the process of developing other tax and expenditure measures that will yield a sustainable improvement in public finances.

In the area of monetary and credit policies, the authorities acknowledge that, although production and commerce have been shrinking, the supply of domestic liquidity has continued to grow, contributing to pressure on prices and maintaining the overhang of excess liquidity already in the economy. Thus, the introduction of effective discipline and control on overall credit expansion will be critical for reducing the financial disequilibria. Until now, overall credit planning has been based on the view that financing should accommodate the planned growth in output and commerce, with the result that overall credit expansion has been far in excess of the prudent limits. To limit future domestic credit expansion to amounts consistent with permissible monetary expansion, the authorities agree that effective mechanisms must be established to ensure adherence to quantitative credit limits.

The authorities believe that the exchange rate policy and greater price flexibility are likely to lead to a major inflation; hence, while overall credit targets should entail a cutback in real terms, they should also be sufficiently high to avoid strangulating economic recovery. Although direct quantitative controls will remain the main instrument of credit policy in the near term, the authorities stated that they are also considering the use of indirect credit control mechanisms. They have also indicated their intention to almost double interest rates in the near future from the present level of about 5-7 percent on the lending side. With respect to the possible separation of the central banking and commercial banking functions of the Bank of Mozambique, the authorities have indicated that the step is desirable, but that sufficient qualified staff are not yet available to permit early action. To improve the quality and timeliness of monetary statistics, the authorities plan to introduce a new plan of accounts for the banking system with Fund technical assistance.

The authorities fully recognize that, without measures to improve the financial position of enterprises, effective control over credit expansion will be impossible to achieve. Accordingly, a critical aspect of the financial policies for the next three years will be the definition of measures to increase the autonomy of enterprise managers, to provide them with incentives to cut costs and increase profitability, and to develop and implement production plans in the context of the significant financial constraints that will be applied for the first time.

The Mozambican representatives acknowledge that, as the principal adjustment measures take hold and a more realistic exchange rate policy is pursued, there will be less need for reliance on the comprehensive exchange and trade controls. In the near future, however, no major changes are planned in the restrictive system. The export retention scheme has served to maintain a minimum level of production and exports in the context of the severe foreign exchange shortage. There has been no indication that the bilateral payments agreement with Tanzania will be terminated in the near future. The authorities noted that agreements which may contain bilateral payments features are in effect with three other Fund members (Malawi, Swaziland, Zimbabwe), but they are of relatively limited importance. The information obtained by the staff to date is insufficient to determine whether these agreements involve exchange restrictions under Article XIV or Article VIII of the Fund's Articles.

V. Staff Appraisal

Mozambique's economic and financial situation was already extremely difficult at the time of the first Article IV consultation, and has continued to deteriorate in the ensuing 15 months. The economic contraction that began in 1982 continued in 1985, and, despite recovery from drought, there has been little or no overall growth in 1986. Economic activity has been disrupted by externally supported armed bands, whose periodic attacks have caused destruction (notably of export crops) and spread insecurity. Both industrial and agricultural production remain at levels sharply lower than in 1980-81, the post-independence peak years. The metical is overvalued by several multiples, and the structure of relative prices is highly distorted. All sectors have been affected by the scarcity of imported inputs; essential goods are in short supply all over the country; barter trade is widespread; and there is little demand for the metical. Recorded price rises have reached some 30 percent a year, but there is a substantial degree of repressed inflation in the economy.

Recorded external transactions have virtually collapsed. Merchandise exports total about one fourth, and imports--mostly financed by external grants and credits--about one half, of their respective 1980-81 peaks. Debt service payments to most creditors have been virtually suspended for the past two years. The debt service burden is likely to remain onerous for many years, even with further substantial rescheduling by creditors. Of particular concern for the next year or two is the limited availability, even if there is further debt rescheduling, of untied or otherwise free foreign exchange to service the external debt.

Domestically, an overhang of liquidity has been created by bank financing of the Government's budgetary deficits and of the losses of enterprises. The latter suffer from a scarcity of imported inputs, low capacity utilization (20-30 percent), and poor management and accounting practices. The budgetary performance of the Government has deteriorated seriously, especially in 1986, as the tax base has shrunk while expenditures on goods and services and defense have continued to rise. The budgetary accounts, moreover, substantially understate the extent of the underlying fiscal imbalance, as they reflect only a small part of interest payments due, exclude public enterprise losses, and greatly undervalue expenditures in foreign currency.

Given this background, the staff welcomes the changed approach to policy formulation signaled by the authorities during the recent consultation discussions, and, in particular, their intention to embark on a major adjustment and recovery program in a medium-term framework. The authorities have rightly recognized that substantial reforms in pricing and exchange rate policies will need to be combined with greatly improved financial control and macroeconomic management.

Given the degree of the current distortions, the physical deterioration of the capital base, and the continuing disruption and resource drain associated with the security situation, the timing and magnitude of the beneficial effects of the policy reforms are difficult to predict. The envisaged adjustment and policy reform in Mozambique must be viewed as only the beginning of an extended process that will require perseverance and courage on the part of the authorities, and substantial support from the international community. Notwithstanding the considerable uncertainties, the staff strongly believes that the implementation of the required reforms will have substantial benefits and that such implementation should not be delayed. Indeed, in the situation of Mozambique, a too gradual approach to adjustment carries with it the quite serious risk of failure.

The immediate tasks before the authorities are to institute a more realistic and flexible exchange rate policy, to support it with tight demand management, and to allow relative prices to be corrected; they would thereby encourage a shift of resources to the productive sector, especially to the exporters and producers of import substitutes. A substantial exchange rate adjustment and price correction at the outset would have a greater chance of absorbing the extensive parallel markets in goods and foreign exchange, thus shifting incentives in favor of productive activity and exports while allowing a better chance for financial policies to work. Exchange rate flexibility will yield positive results if it eliminates much of the differential from the parallel market rate reasonably soon. The staff believes that the establishment of a more realistic exchange rate should provide an occasion for reviewing the foreign exchange management system, with a view to introducing a progressive liberalization of the comprehensive restrictions on trade and payments.

The staff feels that increased flexibility in the system of price formation will be crucial for reducing the existing distortions and encouraging a more rational use of scarce resources. In particular, the future recovery of exports and growth will depend critically on the incentives given to agricultural producers: the immediate aim should be to increase substantially the returns to producers by raising export producer prices to remunerative levels. Greater price incentives will need to be supported by improved availability of "incentive" consumer goods to producers in rural areas and by reform of the marketing system to facilitate an increased role of the private sector and stimulate competition. The staff believes that it will be important to ensure continued flexibility in prices: the authorities should keep the system of price formation under careful review, and allow future exchange rate adjustments and cost developments to be reflected in prices without further administrative impediments or delays. The budgetary and allocative effects of the planned subsidies on five staple commodities should be reconsidered to avoid an undue future burden on the fiscal position. To avoid offsetting the effects of exchange rate adjustment and permit a redistribution of income to rural producers, a cautious stance should be followed on wage policy.

The importance of very tight credit policies in the context of the envisaged adjustment cannot be overemphasized. In setting the targets for overall credit expansion, considerable emphasis will have to be placed on reducing the overhang of excess liquidity in the economy and avoiding an overestimation of credit requirements that may risk the emergence of a spiral of price and wage increases. However, it will not be easy for Mozambique to achieve control over credit expansion because economic agents have not been accustomed to financial constraints in planning or managing economic activity. Moreover, a more substantial increase in interest rates than planned currently by the authorities would help to mobilize savings and ease reliance on quantitative credit controls over the medium term. Care should also be taken that changes in responsibility for financing enterprise investments and losses are effected in a way that does not complicate the monitoring of credit expansion.

Without a thoroughgoing reform of enterprise finances, no lasting correction of financial imbalances is possible. The staff welcomes the authorities' intention to invite an IBRD study on reform of the enterprise sector. In the period immediately ahead, the authorities should take the needed decisions to increase enterprise revenues and reduce costs and provide greater autonomy to managers. Introduction of accepted accounting practices and managerial standards will also be essential. In the context of the IBRD study, the authorities will then need to make critical decisions on the viability of individual enterprises, the promotion of productive investments, the possible reversion of some production and marketing activities to the private sector, and the encouragement of greater competition among enterprises.

The staff is concerned by the further deterioration occurring in Mozambique's fiscal accounts in 1986 and believes that strong actions are needed to bring about a sufficient correction of the budgetary imbalance in the medium term. As the underlying fiscal imbalance is considerably greater than it appears from the data, the reductions in the budgetary deficit will have to be correspondingly more substantial. In this connection, the staff urges the authorities to define their budgetary objectives in terms of the overall budget balance and not as at present only of the current budget. In addition to the measures currently planned, the authorities should undertake a thorough review of tax and expenditure policies. A careful evaluation of the low tax base in Mozambique should be conducted, with a view to bringing it more nearly in line with levels in neighboring countries and resource requirements generated by Mozambique's security situation. In addition, there is scope for improving the elasticity of the tax system by converting certain specific taxes to ad valorem rates and introducing user fees for some services. However, the main avenue for increasing revenue will be the early establishment of prices that reflect scarcity values, so as to absorb the parallel markets and help restore the tax base. Also in the more immediate future, the Government should conduct a critical review of expenditure and limit outlays to the absolute minimum.

Mozambique's economic and financial difficulties stem from both weaknesses in demand management and structural problems; hence, continued close Fund-Bank collaboration will be essential. The IBRD staff shares our view that medium-term structural reforms will play a crucial role in establishing the basis for economic rehabilitation and gradual recovery in Mozambique. As the anticipated IBRD review of the public expenditure and investment program may not be completed until 1988, the IBRD's policy recommendations on sectoral investment plans, which are already being developed, should play a crucial role in determining the adequacy and appropriateness of the composition of investment outlays in the immediate future. In addition, the major IBRD study of the enterprise sector should advance quickly enough that its main conclusions can be incorporated early in the SAF program. Other important IBRD contributions may cover technical assistance related to financial and economic management and to the agricultural sector, and rehabilitation.

Mozambique maintains exchange restrictions under Article XIV of the Fund's Articles, including a bilateral payments agreement with Tanzania, and has accumulated substantial external payments arrears subject to approval under Article VIII and government defaults. Since the last consultation, the staff has been informed that Mozambique maintains bilateral arrangements with three additional Fund members. The staff has asked the authorities to furnish further information for a determination to be made as to whether these arrangements are subject to approval under Article VIII. The staff believes that the authorities should adopt policies that will enable the arrears and bilateral payments arrangements to be eliminated as soon as possible. In the meantime, the staff is not recommending Executive Board approval for the exchange restrictions.

The package of adjustment measures discussed thus far with the Mozambican representatives is not sufficiently concrete to permit an assessment of its adequacy to achieve the needed adjustment and bring about the desired economic recovery. Mozambique's prospects are uncertain, not the least because of continuing security problems. The staff therefore welcomes the authorities' intention to develop more concretely the policy elements of a medium-term policy framework paper relating to use of Fund resources under the structural adjustment facility. A top priority in this context is the further elaboration of realistic medium-term fiscal, balance of payments, and structural adjustment objectives. Careful consideration will also need to be given to the level and composition of imports, which will greatly influence the pace and pattern of economic recovery. Meanwhile, the proposed establishment, possibly with external technical assistance, of a special unit to monitor the implementation of such a program should be accelerated.

Given the critical external payments situation, it is recommended that the next Article IV consultation be carried out on the standard 12-month cycle.

VI. Proposed Decision

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

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 1986 Article XIV consultation with the People's Republic of Mozambique, in the light of the 1986 Article IV consultation with the People's Republic of Mozambique conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. 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 urges the authorities to adopt adjustment policies that will permit the elimination of these restrictions, and to terminate the bilateral payments agreement that is maintained with a Fund member.

MOZAMBIQUE - Relations with the Fund
(As of September 30, 1986)

I. Membership Status

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

A. Financial Relations

II. General Department (General Resources Account)

(a) Quota:	SDR 61.0 million
(b) Total Fund holdings:	100.0 percent of quota
(c) Fund credit:	None
(d) Reserve tranche position:	None

III. Current Extended Arrangement and Special Facilities: None

IV. SDR Department

(a) Net cumulative allocation:	None
(b) Holdings:	None
(c) Current designation plan:	None

V. Administered Accounts: None

VI. Overdue Obligations to the Fund: None

B. Nonfinancial Relations

VII. Exchange Rate Arrangements: The metical, the currency of Mozambique, is pegged to a weighted basket of currencies consisting of the deutsche mark, French franc, Portuguese escudo, pound sterling, South African rand, and U.S. dollar. On December 31, 1985, the buying and selling rates for telegraphic transfers in U.S. dollars were Mt. 41.167 and Mt. 42.007, respectively, per U.S. dollar.

VIII. Consultation with the Fund: The first Article IV consultation discussions were held in Maputo during March 28-April 10, 1985. Executive Board discussions of the staff's reports (SM/85/158 and SM/85/169) took place on July 3, 1985, and the following decision was adopted:

> 1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Mozambique, in the light of the 1985 Article IV consultation with Mozambique conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

MOZAMBIQUE - Relations with the Fund (concluded)

2. Mozambique maintains restrictions on payments and transfers for current international transactions, including external payments arrears, and a multiple currency practice as described in SM/85/158. The Fund encourages the authorities to liberalize these restrictions as soon as possible, and to terminate the bilateral payments agreement that is maintained with a Fund member.

Although the authorities had expressed a preference for the next Article IV consultation discussions not to take place until July 1986, it was expected that consultations with Mozambique would in principle take place on the standard twelve-month cycle.

IX. Technical Assistance

1. Statistics (see also Appendix III). An initial Bureau of Statistics mission in August 1985 assessed Mozambique's needs for technical assistance in several areas of statistics; it also reviewed balance of payments methodology and issued a report with several recommendations 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. Assistance on price statistics, offered in early 1986, has been rescheduled tentatively for October 1986.

2. CBD Advisors. A Central Banking Department staff member visited Maputo in August 1985 (in conjunction with the statistics mission) to assess needs for banking advisors. As a result, a Macroeconomic Advisor from the panel of experts was provided to the Bank of Mozambique in February 1986 for an initial term of one year. An Accounting Advisor has been charged with revising the plan of accounts, beginning in May 1986 for an initial one-year term.

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.

MOZAMBIQUE - Relations with the World Bank

The first World Bank economic mission to Mozambique took place in November 1984, followed by an energy assessment mission in April-May 1985 and a visit by Vice President Jaycox in May 1985. Based on the findings of these visits, an "Introductory Economic Survey" was issued in June 1985. On June 18, 1985, the Executive Board also approved an IDA credit of SDR 45.5 million for an emergency rehabilitation program providing selective balance of payments support. A seminar on World Bank policies and procedures, organized by Bank staff, took place in Maputo in October/November 1985. Another economic mission, including a visit by the program's department director, followed in November 1985, overlapping in the field with the Fund mission. It discussed the possibility of another rehabilitation credit and the supporting policy framework, but the envisaged credit is still at an early stage of identification, pending movement by the authorities in regard to policy reform.

Bank activity in the first several months of 1986 has focused on sectoral work and technical assistance. An education sector mission in March 1986 reviewed the implementation and financial implications of the authorities' ongoing education reform, and began discussions on possible Bank assistance. Sector work in the transportation sector, focussing on the prospects for rehabilitation of the Beira rail and port corridor (to neighboring countries), is under way. Funding for four studies in the agricultural sector (for reviews of the cashew, irrigation, cotton, and forestry subsectors) was approved in May 1986. In July, Bank staff visited Maputo to review with the authorities the terms of reference of an in-depth Bank-financed review of selected agricultural and industrial enterprises, to review the draft energy sector assessment, and to appraise technical assistance projects in the energy sector and in public sector management.

MOZAMBIQUE--Statistical Issues

Despite recent improvements, Mozambique continues to have a weak statistical data base. There is no system yet in place for the regular reporting of statistical data to the Fund's Bureau of Statistics, and there is no country page for Mozambique in IFS, the GFS Yearbook, or Balance of Payments Statistics. There remain large, unresolved discrepancies between fiscal, monetary, balance of payments and external debt accounts, and substantial lags in data compilation and reporting.

1. General economic data

In national accounts, estimates of gross domestic product are available only in terms of expenditure and at current prices. Value-added and constant-price data are not yet prepared. The prototype of a consumer price index, providing annual observations on the basis of family expenditure surveys, has recently been published, and monthly sampling of some items has begun, but a conventional, monthly CPI is not yet available. While a reliable indicator of export prices is available from volume and value data, compilation of an import price index based on customs data is still under way. Technical assistance has been provided by UNIDO and ECA and offered by the Bank and the Fund.

2. Government finance

Government finance statistics are judged to be relatively reliable, particularly those relating to the current state budget, but data on investment outlays and on external grants and loans and debt service are less so. Financial accounts of most public enterprises are weak or not available, and no consolidated accounts of the public sector exist.

3. Monetary accounts

Available monetary data are based on outdated and ambiguous systems of accounts, nd compilation is also hindered by communications difficulties and equipment shortages. A draft new plan of accounts for the banking system and a simplified balance sheet for the financial institutions were produced during the November 1985 technical assistance mission and discussed again with the technical assistance mission on computerizing financial data in late April-early May 1986. Further review and revision prior to implementation is now under way with the CBD accounting expert who arrived in May 1986. At present, the only money and banking data available are year-end accounts for 1980-83 and somewhat more refined and quarterly accounts for 1984-85; monthly data for 1985 and 1986 are being prepared. Thus far, however, the data are based on the old plans of accounts, and a lag of several months remains for current data.

4. Balance of payments

Although a serviceable balance of payments statement has been assembled from exchange control and trade data, substantial problems of timing and coverage remain, as well as a lack of comparability with fiscal and external debt data. The report of an August 1985 Fund technical assistance mission was sent to the authorities in December 1985. Data submissions, however, are not yet made to the Bureau of Statistics.

5. External debt

Although a commercially developed external debt reporting and management system has been provided to the Bank of Mozambique under bilateral assistance, the information within it, however, remains subject to frequent revision and additions, and is not linked with related financial accounts. Data are available by creditor, but debtor institutions are not identified. Mozambique does not yet provide data under the World Bank's debtor reporting system, and the aforementioned data do not meet Bank requirements.

Mozambique: Selected Economic and Financial Indicators, 1981-86

	1981	1982	1983	1984	1985	1986 Est.
	(Annual percentage change, unless otherwise specified)					
National income and prices						
GDP at current prices	4.2	13.3	-11.9	19.3	35.1	22.4
GSP at current prices	7.5	6.7	-9.1	4.2	40.0	...
GSP at constant prices	2.3	-6.3	-18.2	-10.1	-7.9	...
GSP deflator	5.0	14.3	10.8	15.8	52.6	...
Consumer prices	2.0	18.6	28.1	28.4	29.1	30.0
External sector (based on U.S. dollars)						
Exports, f.o.b.	--	-18.4	-42.6	-27.3	-19.9	4.4
Imports, c.i.f.	--	4.3	-23.9	-15.2	-21.5	-13.3
Export volume	-2.7	2.6	-45.5	-35.5	-18.5	...
Import volume	-9.9	-5.2	-28.9	-21.1	-19.9	...
Terms of trade	4.9	-16.3	9.3	16.6	-0.2	...
Nominal effective exchange rate	3.9	7.7	1.9	9.6	13.7	-1.9
Exchange rate (average, US$/Mt.)	-8.3	-6.2	-6.2	-5.3	-1.7	8.0
State budget						
Total revenue (excluding grants)	21.7	36.1	-11.2	-2.4	-15.2	-1.8
Total expenditure	24.9	23.9	6.1	2.4	-20.5	24.6
Money and credit						
Domestic credit	25.6	17.1	41.0	20.7	16.1	23.8
Government (net)	278.2	-39.1	251.8	64.1	21.4	44.8
Economy	16.8	23.5	29.2	14.1	14.9	18.3
Money and quasi-money	29.3	30.3	21.9	15.4	15.4	20.0
	(In percent of GDP) 1/					
Consumption	100.0	103.4	110.9	106.2	103.0	99.6
Investment	18.7	18.4	15.1	11.1	7.3	8.9
Resource gap (-)	-20.1	-22.8	-20.8	-16.6	-9.9	-8.9
Money and quasi-money	56.1	64.5	79.5	76.8	65.6	64.3
Balance on current budget	2.7	6.3	0.4	0.5	-3.4	-4.5
Government overall deficit						
Excluding grants	-11.8	-10.5	-16.2	-14.9	-7.9	-10.9
Including grants	-9.6	-7.9	-12.9	-12.2	-5.9	-8.7
External current account deficit						
Excluding transfers	-20.2	-23.6	-22.5	-18.7	-12.5	-12.2
Including transfers	-17.7	-20.3	-18.3	-12.2	-8.4	-8.1
External debt (year-end)	47.0	60.6	68.4	63.8	59.3	50.2
Including arrears	47.0	60.6	81.0	93.1	85.0	80.5
	(In units stated)					
Overall balance of payments deficit (US$ millions)	-66.5	-142.9	-328.3	-362.3	-365.6	-489.9
Gross foreign reserves (months of imports, c.i.f.)	3.1	0.9	0.9	1.5	1.4	...
Debt service ratio 2/	76.4	98.8	131.9	98.0	102.7	267.2
Memorandum items:						
GDP (Mt. billions)	81.5	92.3	91.2	108.8	147.0	180.0
GDP (US$ millions)	2,306	2,448	2,270	2,564	3,404	4,500
Mt./US$ (average)	35.350	37.750	40.183	42.443	43.181	40.000

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

1/ Ratios may be increasingly understated to the extent that numerators are at official prices whereas much of the value of the denominator (i.e., private consumption) reflects a mixture of official and parallel-market prices.

2/ Scheduled external debt service as percent of exports of goods and services (including workers' remittances), after reschedulings of 1984-85.