Mozambique and the IMF

Press Release:
Press Release: IMF Completes First Review Under the Policy Support Instrument for Mozambique
December 13, 2010

Country's Policy Intentions Documents

Mozambique: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

November 8, 2010

REPUBLIC OF MOZAMBIQUE: LETTER OF INTENT

Mr. Dominique Strauss-Kahn November 8, 2010
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. Strauss-Kahn:

The Government of Mozambique requests the completion of first review under the Policy Support Instrument (PSI). In support of this request, we are transmitting the attached Memorandum of Economic and Financial Policies (MEFP), which reviews implementation of our economic program under the PSI and sets out the Government's objectives and policies over the short and medium term.

The Government's economic program aims to maintain macroeconomic stability, promote diversified and strong economic growth, and reduce poverty. The Government intends to finalize its next Poverty Reduction Strategy Paper (PARP) for 2011-14 in early 2011, before the second review of the PSI-supported program.

The Government met all quantitative assessment criteria (AC) through end-June 2010, except for the one on reserve money, which was exceeded by a small margin and for which we request a waiver. We also made strong progress in implementing our structural reform program.

The Government believes that the policies outlined in the MEFP are adequate to achieve the objectives of the PSI-supported program. We stand ready to take any additional measures necessary to achieve our policy objectives. The Government will consult with the IMF—at its own initiative or whenever the Managing Director requests such a consultation—should revisions be contemplated regarding the policies contained in the attached MEFP. The Government will provide the IMF with such information as the IMF may request to be able to assess the progress made in implementing the economic and financial policies and achieving the objectives of the program.

Sincerely yours,

/s/	/s/
Manuel Chang	Ernesto Gouveia Gove
Minister of Finance	Governor, Bank of Mozambique

Attachments: Memorandum of Economic and Financial Policies
Technical Memorandum of Understanding

ATTACHMENT 1

REPUBLIC OF MOZAMBIQUE: MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

I. INTRODUCTION

1. **We firmly reiterate our commitment to the medium-term objectives of our economic program supported under the PSI.** The program aims to preserve macroeconomic stability while supporting the Government's economic development objectives, with a view to creating an environment conducive to private sector activity. To this end, as laid out in the MEFP dated May 24, 2010, we aim to (i) encourage additional national and foreign direct investment in the natural resources sector; (ii) significantly step up our public investment in transport and electricity infrastructure, to be partly financed by nonconcessional external resources; (iii) improve the business climate; and (iv) reap the benefits from regional integration.

2. **The forthcoming drafting of the new five-year PARP will offer an opportunity to step up our pro-poor development agenda**. Conjointly with the private sector, civil society, and development partners, we will assess the scope to redouble our efforts to strengthen inclusive economic growth and improve the plight of the poor.

II. RECENT ECONOMIC DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM

3. **Mozambique has been faced with a difficult external environment.** Although the global crisis has not slowed down economic growth, it has impacted Mozambique's balance of payments and required accommodating monetary and fiscal policies. Taken together, these developments have contributed to a depreciating exchange rate and a rise in inflation, which have caused a considerable burden for the most vulnerable segments of the population.

4. **Nonetheless, Mozambique's macroeconomic performance remains strong overall.** Real GDP growth could reach 7¼ percent in 2010, benefiting from strong activity across all sectors. The external current account deficit (after grants) is projected to widen to 13½ percent of GDP in 2010, as the rise in megaprojects exports largely offsets the drop in nontraditional exports, and surge in fuel imports, and rise in global food prices. Private capital inflows have begun to recover, but Mozambican companies continue to offset their traditional reliance on international credit markets with domestic bank financing. Inflation is expected to average close to 13 percent in 2010.

5. **Faced with the rise in inflation, the Bank of Mozambique (BM) has tightened monetary policy since mid-year.** In June and September, it cumulatively raised the key policy rate and reserve requirements by 4 and ¾ percentage points, respectively. It has also stepped up sales of foreign exchange in particular to mop up liquidity and help stabilize the exchange rate.

6. **Fiscal policy implementation has been prudent to date.** Tax collections have been buoyant, as economic activity has remained strong and the Government reaps the gains from our ongoing tax administration reforms. The Government has proceeded very carefully in executing

the 2010 budget. This provided welcome room, since we needed to adjust spending composition during the course of the year. First, in early September, we adopted emergency measures to help shield the poor from rising prices, which is expected to cost MT 0.5 billion (¼ percent of GDP) in 2010. Second, the costs of the fuel subsidy exceeded the budgeted amount by MT 2.9 billion (0.9 percent of GDP), as global fuel prices and fuel demand rose stronger than projected.

7. **The Authorities have persevered in meeting their commitments under the program.** All the quantitative targets for end-June 2010 were met, except the AC for reserve money which was exceeded by a small margin and for which we request a waiver. The new methodology of averaging reserve money helped the BM improve its monitoring of the program target, although the spike in currency toward the end of the month continues to be difficult to predict. With respect to the structural benchmarks, (i) the new PPP, Concessions and Megaprojects Law was adopted by the ministerial Economic and Social Council on September 30, 2010 and the Council of Ministers on October 5, 2010; and (ii) the first Government debt sustainability analysis was completed on September 30, 2010 and, following discussion with Fund staff, will be published on the Government's website by November 15, 2010.

III. POVERTY REDUCTION AND GROWTH STRATEGY

8. **The Government remains concerned about the extent of poverty**. The recently released *Third National Poverty Assessment*, based on 2008/09 household survey data, indicates that the poverty incidence has remained broadly constant over the last six years, despite Mozambique's impressive growth over the last decade. On the other hand, it also highlights that progress has been good with respect to access to education, health, and other basic social services, thanks to the Government's policies and donor support.

9. **Against this background, the Government has initiated the process of drafting its new Poverty Reduction Strategy (PARP).** As in the past, we intend to pursue a consultative process with the private sector, civil society, and development partners in drafting the document, which is expected to be adopted by the Council of Ministers by end-March 2011. The Government's focus is on making economic growth more inclusive, by broadening economic activity outside the megaprojects sector, thereby generating employment opportunities, raising household livelihoods, and improving food security. This could include the development of sectoral strategies, such as for agriculture and tourism, as well as a redoubling of efforts to improve the business environment. The Government expects that such efforts would complement their current emphasis on rapidly expanding the country's infrastructure in the transportation and energy sectors, which has been a key pillar of its economic program supported under the PSI.

10. **The Government aims at building sustainable social safety nets to help reduce poverty while stimulating the local economy.** We will assess the emergency measures adopted in early September by year-end in order to determine the scope to replace them with more permanent and possibly better targeted measures over time. Through the implementation of our multi-sectoral *National Basic Social Security Strategy* (ENSSB), approved by the Council of Ministers in April 2010, and the *Strategic Program for the Reduction of Urban Poverty* (PERPU), the Government will gradually expand support to the most vulnerable. Drawing on the

experience of other countries, we place emphasis on creating productive safety nets that aim at providing cash and other support in the short run while strengthening Mozambique's long-term growth potential. We have begun discussing possible options with the World Bank, UNICEF, and other development partners to secure their technical and financial support. The Government intends to create adequate fiscal space in the medium-term fiscal framework (CFMP) to support the implementation of such safety nets.

IV. MACROECONOMIC POLICIES

A. Economic Objectives

11. **The Government sees a favorable economic outlook for Mozambique.** Economic growth could reach 7½ percent in 2011 and accelerate to 8 percent over the medium term. Following a concerted effort by the Authorities, average inflation is expected to decelerate to 8 percent in 2011 and approximate our medium-term objective of 6 percent from 2012 onward. The external current account deficit (after grants) should hover at around 12½ percent of GDP over time, reflecting a continued recovery in export receipts that more than compensates the large import demand related to the country's strong public and private investment needs. Strengthening private capital inflows, continued donor support, and Government external borrowing for infrastructure investment should keep Mozambique's international reserves at a comfortable level, at about 5 months of imports over the medium term.

B. Macroeconomic Policy Mix

12. **We reiterate our commitment to preserving macroeconomic stability.** The Government and BM recognize that macroeconomic stability is one of Mozambique's strongest assets and instrumental in creating a predictable framework for private sector activity.

13. **In the short run, the Government and BM will give priority to reigning in inflation.** To this end, in 2011, we will unwind the monetary and fiscal stimulus adopted in the wake of the global crisis. The BM will rebalance the extent of liquidity in the economy, as the impact of the global crisis on Mozambique tapers off. In order to contribute to a lowering of demand pressures, the Government will temporarily pursue a tighter fiscal policy stance, thus limiting its recourse to domestic financing and helping avoid a crowding out of the private sector. We expect that the macroeconomic policy mix will return to normalcy during the course of 2011.

14. **Over the medium term, we will follow a policy stance that preserves macroeconomic stability and debt sustainability while supporting economic development.** Our objective is to keep the domestic primary fiscal deficit at around 4 percent of GDP over the medium term and limit the Government's domestic financing requirement through a determined revenue effort and the prioritization of domestic spending. This, coupled with a prudent monetary policy stance, should ward off demand pressures and support achievement of our inflation objective. At the same time, we intend to step up our capital spending to boost infrastructure investment, to be partially financed by nonconcessional external borrowing (NCB). The Government will pace the

implementation of public investment in a way that is consistent with macroeconomic and capacity constraints so as to avoid the emergence of domestic demand pressures.

C. Monetary and Exchange Rate Policies

15. **The BM is determined to bring inflation back to single digits in 2011 and reiterates its medium-term objective of 6 percent.** In light of the current surge in headline inflation, it will use its full set of monetary policy instruments to decelerate money growth. This will result in a significant slowdown in reserve money growth relative to nominal GDP growth during the remainder of 2010 and in 2011. The BM will use open market operations to swiftly mop up liquidity, mainly through foreign exchange interventions and t-bill sales. It will continue to signal its determination to markets through adjustments in its key policy rates and reserve requirements, if needed.

16. **In its monetary policy implementation, the BM will continue to pay close attention to the real effective exchange rate vis-à-vis a broad basket of currencies.** The BM reiterates its adherence to the general principle that the exchange rate should adjust freely to evolving patterns of trade and financial flows while safeguarding Mozambique's international reserves.

17. **The BM intends to strengthen its monetary policy operations framework, in line with Fund technical assistance recommendations.** All those enhancements are part of the BM's efforts to move to an inflation targeting framework in the long run, as specified in the relevant action plan. Specifically, the BM will take the following steps in this direction:

- With a view to strengthening repo operations, eliminating distortions in the pricing of Government securities, and facilitating the build-up of a yield curve, the BM will issue, by end-January 2012, regulations and institute procedural changes that would (i) make t-bills fungible in the MMI (*Meticalnet Interbank Money Market*); and (ii) allow all Government securities to be used as collateral for monetary policy operations.

- In order to improve liquidity forecasting and the predictability of budget execution through the treasury single account (CUT), by end-March 2011 the Ministry of Finance and the BM will sign a Memorandum of Understanding stipulating (i) the phased–in provision to the BM of timely information on all Government actual and projected expenditures and receipts; (ii) the regular exchange of information on the government's cash flow forecast, liquidity projections, and foreign exchange flows; and (iii) the timely provision of reliable data by the BM on government financial transaction through the CUT.

18. **We intend to notify the Fund of our acceptance of the obligations under Article VIII sections 2, 3, and 4 of the Fund's Articles of Agreement by end-December 2010.** In our view, the new foreign exchange regulations, which we expect to be adopted during December 2010, will remove all existing and potential exchange restrictions, consistent with the recommendations of the recent Fund technical assistance mission. Apart from the regulatory aspects, the BM is committed to continue monitoring the functioning of the foreign exchange market, with a view to avoiding practices that could turn out to be inconsistent with Article VIII principles.

D. Fiscal Policy

Fiscal policy stance

19. **The Government will follow a fiscal policy stance consistent with the monetary tightening to avoid a crowding out of the private sector:**

- For 2010, it will limit the domestic primary fiscal deficit to 4.1 percent of GDP, which should contain the banking system's net credit to the Government (NCG) at 0.3 percent of GDP. Achieving these targets requires a substantial dedication to enhance tax collections and reduce non-priority spending. This is in light of the larger-than-expected outlays for the fuel subsidy and the emergency measures to restore social peace. Consequently, while the wage bill will be at budgeted levels, the Government is prepared to forego executing domestically-financed capital spending and current spending during the remainder of 2010 should this become necessary to achieve the NCG target.

- Fiscal policy will step up its contribution to containing inflation in 2011. We will reduce the domestic primary fiscal deficit by 0.9 percentage points, to 3.3 percent of GDP, resulting in a virtually zero recourse to domestic financing. The program's indicative revenue floor is prudently set ½ percent of GDP below the ambitious objectives of the 2011 budget law, but the Revenue Authority will be instructed to collect the full revenue target under the budget law (19½ percent of GDP).

20. **The implementation of the 2011 budget law will be subject to the revenue contingency under the organic budget law (SISTAFE 2002).** This legal framework limits budget execution to cautionary ceilings as long as revenue collections remain uncertain. To this end, and in accordance with the legal provisions of the 2011 budget law, the Government will take the following steps by end-January 2011: (i) the Council of Ministers will approve the decree on the provisions regarding budget execution (*Delegacao de Competencia sobre a Excecucao do Orcamento*); and (ii) the Minister of Finance will issue an interministerial regulation (*Circular Ministerial*) providing guidance for line ministries for budget execution and contingencies. Accordingly, the following contingency ceilings will apply: (i) 90 percent for goods and services and other current expenditures; (ii) 85 percent for civil service wages and transfers; and (iii) 90 percent for domestically-financed capital spending.

Priority spending

21. **The tight fiscal policy stance will not affect allocations for priority sectors.** The Government will protect priority spending, as defined by PARP, and meet the program's indicative floor on such spending for 2010 (MT 58.4 billion). The relevant target for 2011 is MT 63.0 billion; however, the Government expects that priority spending will be redefined under the new PARP, in consultation with development partners and civil society, requiring a likely revisiting of the 2011 spending floor at the time of the second PSI review.

Wage policy

22. **The Government aims to strike the proper balance between modernizing the civil service and keeping the wage bill in line with macroeconomic needs.** While furthering ongoing reforms, we will aim to stabilize the wage bill, after two years of rapid increases.

- The new salary policy, adopted in 2008, aims to (i) simplify and rationalize the salary scales across ministries, (ii) decompress the scales consistent with qualifications and responsibility, (iii) reform the system of housing and other allowances, and (iv) harmonize the salary policy with the pension system. By end-March 2011, the Government will review the implementation strategy of the new salary policy, with a particular focus on its budgetary implications. The future implementation of the new salary policy will be gradual, consistent with macroeconomic circumstances.

- To enhance the real-time control over the wage bill, we will expand the electronic payroll reporting system (e-FOLHA) and have all salaries paid at the level of central Government institutions reported through e-FOLHA by end-June 2011. We will also roll out e-FOLHA to at least three Directorates in each province by end-December 2011. In parallel, we will strengthen the mechanism for updating the civil servant master database record (e-CAF) at the central, provincial, and district level. The enhancements to e-FOLHA and e-CAF will allow the generation of quarterly reports on the civil servant population, wage payments by sector, and the impact of promotion and recruitment decision at all levels. After a testing phase, the first such report will be issued by end-July 2011 **(structural benchmark)**.

- Given the current inflationary pressures, the Government issued circular 05/2010 dated September 9, that, inter-alia, restricts promotions for this year in order to stay within the ceiling on the wage bill in the annual budget law.

- These efforts notwithstanding, we will continue our recruitment program for priority sectors, hiring 13,000 staff in 2011, of which 73 percent are for health and education.

Fuel subsidy

23. **The Government is committed to a full pass-through of fuel prices.** To limit fiscal risks, lessen the country's import bill, and safeguard international reserves, the Government will regularly review the price structure of fuel products. It will consider various options to limit the costs coming from the remaining discrepancies between import and retail prices for diesel. This could include a cross-subsidization between various fuel categories, but also limiting the current adjustment factor in the monthly fuel price formula to retail prices at the pump, thus charging market prices to wholesale customers. The Government will consider the implications of its fuel price policy on the most vulnerable segments of the population and introduce other support measures, as deemed appropriate. To ensure transparency, the Government will explicitly show the full costs of any Government outlays for fuel products in budget documents.

Public investment in infrastructure

24. **The Government attaches great importance to expanding Mozambique's infrastructure in the energy and transportation sectors.** This is motivated by our desire to strengthen the country's productive base and provide a catalytic effect for private sector activity. In this undertaking, the Government will give priority to safeguarding the significant support from development partners whose concessional resources have helped Mozambique preserve very comfortable debt indicators. Nonetheless, the extent of the infrastructure gap requires the Government to also consider NCB for selected projects that promise a high economic return.

25. **The Government's economic program supported under the PSI envisages an overall NCB envelope of US$900 million for the period 2010-13.** This amount has been deemed compatible with the Government's efforts to preserve macroeconomic stability and debt sustainability.

- The continuous AC on NCB for 2010 will be raised to US$300 million at the time of the first PSI review to allow the Government to contract two loans from Brazil for the construction of Nacala airport (US$80 million) and rehabilitation of the port of Beira (US$220 million).

- The AC on NCB for 2011 will be set at the full remaining amount of US$ 600 million under the program envelope in order to facilitate the government's negotiations with potential creditors. Should the signature of the Brazilian loans for the Nacala and Beira projects be delayed from 2010 to 2011, the relevant AC for 2011 will be increased by the 2010 shortfall.

26. **The NCB subject to the related AC will be channeled to growth-enhancing sectors.** It will only be applied to infrastructure investment in energy and transportation (**continuous structural benchmark**). For any NCB-financed projects, the Government will share project feasibility studies—including those from co-financing donors—with Bank and Fund staff.

27. **Among the projects under evaluation by the Government, the following specific projects enjoy the highest priority at present:**

- An expansion of electricity production at the Cahora-Bassa dam in central Mozambique, which should enhance the reliability of the supply of electricity;

- The construction of a power line between the Cahora-Bassa dam and Maputo, which would reduce the dependency on electricity re-imports;

- An expansion of the road network, as currently only about one-third of Mozambique's road infrastructure is asphalted. Possible priority projects could include transit corridors from key economic centers to the borders with neighboring countries, such as the 287 km road connecting the port city of Beira to Machipanda at the border with Zimbabwe or the 131 km road between the capital city Maputo and the Ponta d'Ouro border post with South Africa.

28. **The Government recognizes that the acceleration of the public investment program would need to be consistent with Mozambique's macroeconomic circumstances.** Therefore, the Government commits to carefully monitoring the execution of the public investment program of the central Government, SOEs, agencies, and funds, by making full use of the institutional and budgetary safeguards existing in the current legal framework, and to promptly adapting budget implementation in case of emerging demand pressures. The following safeguards will be applied:

- For entities receiving NCB from the budget, the Minister of Finance will issue a ministerial decree (*Diploma Ministerial*) directing that they submit timely reports of all their financial transactions to the Treasury, via e-SISTAFE or through an agreed data reporting template, as precondition for disbursements. Project execution will be based on the provisions of Decree 23/2004 approved by the Council of Ministers. It requires the Treasury to elaborate a rolling quarterly cash plan to control and eventually slow down spending consistent with available resources. It also provides the legal basis to phase spending in response to macroeconomic conditions.

- For those SOEs, agencies, and funds receiving nonconcessional resources directly from the lender, the relevant contract will be negotiated such that project implementation will be in several phases, providing the Minister of Finance with the authority to slow down initiation of the next project phase should this be warranted by macroeconomic circumstances. Those entities will submit timely quarterly reports on project execution to the Treasury through an agreed data template.

- The annual and quarterly budget execution reports will provide a full account of the state of implementation of those projects.

V. Fiscal Structural Reforms

Public financial management

29. **The Government's focus will be on continuing the rollout of automated systems to facilitate budget execution, and on monitoring and strengthening control of spending execution outside the central Government perimeter**:

- We will further extend the e-SISTAFE budget execution system to cover 45 percent of total spending by end-December 2011, following a projected 37.5 percent for 2010. In the same vein, we will strengthen the direct reporting from e-SISTAFE into the annual budget report (Conta Geral do Estado), which should improve timeliness and reliability of data and accelerate the budget drafting process.

- We will improve the integration of the audit functions into e-SISTAFE. The Court of Auditors (*Tribunal Administrativo*) will issue, by end-December 2010, a decree that external audits can henceforth be based on paper documentation and electronic e-SISTAFE reports, wherever the system is used.

- Finally, by end-April 2011, the *Inspectorate General of Finance* will define specific audit targets for the operations of SOEs, agencies, and funds, and issue an internal regulation guiding the work of the auditors in this area.

Debt management and investment planning

30. **Debt management and investment planning will be strengthened to ensure that our borrowing and investment decisions provide us with the highest value for money:**

- The PPP unit in the Ministry of Finance, intended to serve as a gateway for the PPP pipeline approval process, will be created by end-January 2011 and made fully operational by end-April 2011, with sufficient staffing and resources to implement its work program.

- Following the expected completion of our medium-term borrowing strategy at end-November 2010, we will begin to operationalize the strategy through detailed annual borrowing plans. Such plans will cover domestic and external financing, take into account the likely timing of Government cash flow during the year, and reflect our efforts to develop domestic financial markets and establish a yield curve. Considering the near-zero NCG for 2011 and the need for domestic market development, a first annual borrowing plan will be developed by end-October 2011 for 2012, consistent with the draft 2012 budget law.

- To enhance debt management and project selection, the Government will, by end-March 2011 (i) issue a ministerial decree (*Diploma Ministerial*) to create a *Debt Management Committee (DMC*) as an advisory body to facilitate a systematic and regular coordination of debt management activities and related policies; and (ii) issue a ministerial decree (*Diploma Ministerial*) to create a *Project Coordination Committee* (PCC) to advise the Government on the prioritization and selection of projects. Both committees will comprise representatives of the Ministries of Finance and of Planning and Development, the National Statistical Institute (INE), and the BM. The decrees will specify that the opinions of the DMC and PCC will be an integral part of the Government's process of making investment and financing decisions **(structural benchmark)**.

- With the same objective, the Minister of Planning and Development will issue, by end-March 2011, a ministerial decree (*Diploma Ministerial*) requiring that a project selection protocol and a standard project evaluation template be used by all Government entities in the analysis and selection of public investment projects. Among other things, the decree will establish the roles and responsibilities of individual ministries in project planning and implementation, and set minimum standards for feasibility studies, cost-and-benefit analyses, and financing options. It will also clarify that adherence to the protocol requirements will be a prerequisite for the consideration of an investment project by the Government **(structural benchmark)**.

Tax policy and administration

31. **We will underpin our revenue efforts with continued reforms in tax policy and administration:**

- With a view to expanding the tax base and improving the business climate, we will adopt by end-March 2011, an action plan of priority measures to continue to simplify the tax system, expand the tax base, and assess the merits and feasibility of possibly reducing corporate tax rates and of rationalizing incentives under the tax benefits code (**structural benchmark)**.

- With a view to offsetting the revenue losses from the elimination of SADC customs duties, the Government will strengthen the efficiency of the customs administration. To this end, it will (i) launch the single-window customs management system by March 2011 to streamline customs procedures; (ii) complete the rollout of the single-window system in all main ports and airports by end-2011; (iii) make fully operational, by end-June 2011, a mandatory seals system for alcoholic beverages to ensure that excise duties are duly paid.

- The Revenue Authority will, by end-January 2011, adopt an action plan to expand coverage of the large taxpayers unit. The plan will aim to raise the share of collections from the current 50 percent to 70 percent of revenues in the long run.

EITI Membership

32. **We are committed to become a compliant member of the EITI by end-May 2011.** The EITI Coordination Committee, consisting of representatives from the private sector, civil society, and the Government, has adopted a work program to achieve full EITI membership by that date. With the support of development partners, an EITI secretariat was created to implement the planned activities, such as public awareness campaigns, as well as the selection of an independent auditor and an EITI validator. It is expected that the audit report will be finalized by end-December 2010, reconciling Government tax receipts with tax payments from selected extractive companies. A validator, accredited by the international EITI secretariat in Oslo, is expected to complete the review of the audit report and of the EITI adherence process and submit its report for acceptance by the international EITI secretariat by end-April 2011.

Reform of the National Social Security Institute (INSS)

33. **The Government is committed to strengthening INSS to ensure its financial viability.** The INSS investment strategy will be completed by end-March 2011, stipulating that investment decisions will solely aim at protecting the interests of INSS beneficiaries. The audited and validated 2008 accounts will be approved by the INSS Board and published by end-December 2010, and those for 2009 by end-June 2011. With ILO assistance, we will complete an actuarial study, based on the audited accounts of 2004-08, by end-March 2011; the study will suggest specific measures needed to ensure the financial sustainability of the INSS. Finally, we plan to complete the reform of the INSS organizational structure and IT system in 2011.

VI. FINANCIAL SECTOR POLICIES

34. **The financial sector has played a key role in Mozambique's economic development, which is likely to continue.** It has also been able to provide additional financing when global credit markets became less accessible for local companies in the wake of the global crisis. Despite the progress made, there is a significant need to further promote financial intermediation and access to finance and credit while safeguarding the soundness of the banking system. To this end, we are in the process of finalizing a financial sector development strategy that will be validated in a workshop in early December 2010 and based on the findings and recommendations of the 2009 FSAP update, as well as the results of implementation of the Financial Sector Technical Assistance Project (FSTAP) program and other donor programs. In light of the rapid rise in private sector credit and the envisaged tightening of liquidity, the BM will closely supervise the banking system and monitor overall credit risk.

35. **The Government and BM will pursue the following key financial sector reforms:**

- We intend to open a dialogue with the financial sector, the private sector, and civil society on developing a financial services charter aimed at improving access to finance and credit. This will include discussion of measures to broaden financial sector products, enhance their marketing and distribution channels, strengthen competition, establish a consumer protection program, and improve financial literacy.

- We will speedily embark on putting in place the recently-completed financial sector contingency plan, which was developed with FSTAP support. To this end, by end-April 2011, we will implement the plan modules on prompt corrective action procedures and coordination with foreign supervisors **(structural benchmark)**. All other plan modules will be implemented by end-December 2011. A Financial Stability Committee, comprising the Minister of Finance and BM Governor, will meet as needed to assess financial sector stability issues.

- The BM recently adopted a roadmap for implementing Basel II in its banking supervision and regulation framework, aiming to conclude the migration by early 2014. The emphasis in 2011 will be on providing training to BM staff, for which we will seek technical assistance.

- We have submitted to parliament the draft amendment to the 2002 AML law that will make it compliant with the recommendations of the Financial Action Task Force (FATF) and remove incompatibilities between the law establishing the financial intelligence unit (GIFIM) and the AML law. GIFIM has started recruitment and capacity building, supported by development partners, and should be fully operational by end-June 2011.

VII. PROGRAM MONITORING

36. The modified quantitative AC and indicative targets for end-December 2010, the indicative targets for end-March 2011, and the AC and indicative targets for end-June 2011 are shown in Table 1. Table 2 lists the structural benchmarks for the first half of 2011. The second PSI review is expected to be completed by end-June 2011 and the third PSI review by end- 2011.

MEFP Table 1. Mozambique: Quantitative Assessment Criteria and Indicative Targets [1]
(Millions of meticais, unless otherwise specified)

	2010									2011	
	End-March Indicative Target			End-June Assessment Criteria			End-Sept Indicative Target	End-Dec Assessment Criteria		End-March Indicative Target	End-June Assessment Criteria
	Prog.	Adj. Prog.	Act.	Prog.	Adj. Prog.	Act.	Prog.	Prog.	Proposed	Proposed	Proposed
Assessment/Performance Criteria for end-June/December											
Net credit to the government (cumulative ceiling)	-124	2,669	2,472	-1,743	-660	-1,287	868	933	1,039	1,097	-2,012
Stock of reserve money (ceiling)	21,031	21,531	22,970	24,567	25,067	25,402	25,753	28,173	29,493	27,368	29,156
Stock of net international reserves of the BM (floor, US$ millions)	1,711	1,611	1,685	1,759	1,714	1,742	1,885	1,930	1,675	1,715	1,765
New nonconcessional external debt contracted or guaranteed by the central government or the BM or selected state-owned enterprises with maturity of one year or more (ceiling, US$ millions) [2]	5	5	0	200	200	0	200	200	300	600	600
Stock of short-term external public debt outstanding (ceiling)	0	0	0	0	0	0	0	0	0	0	0
External payments arrears (ceiling)	0	0	0	0	0	0	0	0	0	0	0
Indicative targets:											
Government revenue (cumulative floor)	10,810	10,810	12,156	27,049	27,049	27,943	41,732	56,474	59,940	14,929	34,311
Priority spending (cumulative floor)	…	…	…	…		…	43,562	58,424	58,424	15,899	34,547

Sources: Mozambican authorities and IMF staff estimates
1 For definition and adjustors see the attached Program Monitoring Section of the Memorandum of Economic and Financial Polices and the Technical Memorandum of Understanding.
2 Should the signature of the Brazilian loans for the Nacala and Beira projects be delayed from 2010 to 2011, the relevant AC ceiling for 2011 will be increased by US$300 million.

Table 2. Mozambique: Structural Benchmarks Under the PSI

Any new contracting of nonconcessional external borrowing or guarantees by the Central Government and selected state-owned entities (SOEs) subject to the related continuous quantitative AC (see Table 1) will be for transportation and infrastructure investment, as described in paragraphs 25 and 26.	Continuous
Building on the enhancements to e-FOLHA and e-CAF, a first quarterly report will be issued on the civil servant population, wage payments by sector, and the impact of promotion and recruitment decision at all levels, as described in paragraph 22.	End-July 2011
The Minister of Planning and Development will issue a ministerial decree requiring that a project selection protocol and a standard project evaluation template be used by all Government entities in the analysis and selection of public investment projects, as described in paragraph 30.	End-March 2011
An action plan of priority measures will be adopted to simplify the tax system, expand the tax base, and assess the merits and feasibility of possibly reducing the corporate tax rates and of rationalizing incentives under the tax benefits code, as described in paragraph 31.	End-March 2011
The Government will issue two ministerial decrees to create a Debt Management Committee (DMC) and a Project Coordination Committee (PCC), as described in paragraph 30.	End-March 2011
The BM will begin putting in place the recently-completed financial sector contingency plan, by implementing the plan modules on prompt corrective action procedures and coordination with foreign supervisors, as described in paragraph 35.	End-April 2011

ATTACHMENT 2

REPUBLIC OF MOZAMBIQUE: TECHNICAL MEMORANDUM OF UNDERSTANDING

November 8, 2010

1. This Technical Memorandum of Understanding (TMU) defines the quantitative assessment criteria, indicative targets, and structural benchmarks on the basis of which the implementation of the Fund-supported program under the Policy Support Instrument (PSI) will be monitored. In addition, the TMU establishes the terms and timeframe for transmitting the data that will enable Fund staff to monitor program implementation.

I. DEFINITIONS

Net credit to the central government

2. Net credit to the central government (NCG) by the banking system is defined as the difference between the outstanding amount of bank credits to the central government and the central government's deposits with the banking system, excluding deposits in project accounts with the banking system, recapitalization bonds issued to the BM, and proceeds from the signing fee for mineral resource exploration. Credits comprise bank loans, advances to the central government and holdings of central government securities and promissory notes. NCG will be calculated based on data from balance sheets of the monetary authority and commercial banks as per the monetary survey. The limits on the change in NCG by the banking system will be cumulative from end-December of the previous year.

3. The central government encompasses all institutions whose revenue and expenditure are included in the state budget (*Orçamento do Estado)*: central government ministries, agencies, and the administration of 11 provinces. Although local governments (43 municipalities or *autarquias*) are not included in the definition because they are independent, the bulk of their revenue is registered in the state budget as transfers to local governments.

Government revenue and financing

4. Revenue is defined to include all receipts of the General Directorate of Tax (*Direcção Geral dos Impostos,* DGI), the General Directorate of Customs (*Direcção Geral das Alfândegas,* DGA), and nontax revenue, including certain own-generated revenues of districts and some line ministries, as defined in the budget. Net receipts from privatization received by the National Directorate of State Assets (*Direcção Nacional do Património do Estado*) and unrealized profits transferred by the central bank to the treasury will not be considered as revenue (above the line) and will be accounted for as other domestic financing (below the line).

5. For the purpose of program monitoring, revenue is considered as collected at the time when it is received by the relevant government collecting agencies, in cash or checks, or through transfers into the respective bank account.

Priority social spending

6. Priority social spending is based on the PARPA program categories. Accordingly, it will include total spending in the following sectors: (i) education; (ii) health; (iii) HIV/AIDS; (iv) infrastructure development; (v) agriculture; (vi) rural development; and (vii) governance and judicial system.

Reserve money

7. For the purposes of program monitoring reserve money is defined as the sum of currency issued by the BM and commercial banks' holdings at the BM. The target is defined in terms of the average of the daily end-of-day stocks in the month of the test date. The reserve money stock will be monitored and reported by the BM.

Net international reserves

8. Net international reserves (NIR) of the BM are defined as reserve assets minus reserve liabilities. The BM's reserve assets include (a) monetary gold; (b) holdings of SDRs; (c) reserve position at the IMF; (d) holdings of foreign exchange; and (e) claims on nonresidents, such as deposits abroad (excluding the central government's savings accounts related to mineral resource extraction concessions). Reserve assets exclude assets pledged or otherwise encumbered, including but not limited to assets used as collateral or guarantee for a third–party external liability (assets not readily available). The BM's reserve liabilities include: (a) all short-term foreign exchange liabilities to nonresidents with original maturity of up to and including one year; and (b) all liabilities to the IMF.

New nonconcessional external debt contracted or guaranteed by the central government, the BM, and selected state-owned enterprises, with maturity of more than one year

9. The ceiling on nonconcessional external debt applies to external debt contracted or guaranteed by the central government, the BM, the Road Fund, the water authorities (FIPAG), and the electricity company (EDM). It also applies to debt contracted by these three state-owned enterprises from domestic banks or from other state-owned enterprises that is contractually inter-related to external nonconcessional loans.

10. The ceiling applies to external debt with original maturity of one year or more and with a grant element below 35 percent. The grant element is calculated using currency-specific discount rates based on the Organization for Economic Cooperation and Development (OECD) commercial interest reference rates in accordance with the annual Budget Law. The term 'debt' will have the meaning set forth in Point 9 of the Guidelines on Performance Criteria with Respect to External Debt in Fund Arrangements adopted on August 3, 1979, as amended August 31, 2009, effective December 1, 2009. The concept of external debt is defined on the basis of the residency of the creditor. The ceiling also applies to commitments contracted or guaranteed for which value has not been received. This assessment criterion will be assessed on a continuous basis.

Stock of short-term external public debt outstanding

11. The central government will not contract or guarantee external debt with original maturity of less than one year. This assessment criterion applies not only to debt as defined in Point 9 of the Guidelines on Performance Criteria with Respect to External Debt in Fund Arrangements adopted on August 3, 1979, as amended August 31, 2009, effective December 1, 2009, but also to commitments contracted or guaranteed for which value has not been received. Excluded from this assessment criterion are short-term, import-related trade credits. This assessment criterion will be assessed on a continuous basis.

External payments arrears

12. The government undertakes not to incur payments arrears on external debt owed or guaranteed by the central government, with the exception of external payments arrears arising from government debt that is being renegotiated with creditors. This assessment criterion will be assessed on a continuous basis.

Foreign program assistance

13. Foreign program assistance is defined as grants and loans received by the Ministry of Finance through BM accounts excluding those related to projects (Table 1).

Actual external debt service payments

14. Actual external debt service payments are defined as cash payments on external debt service obligations of the government and central bank, including obligations to Paris Club and other bilateral creditors rescheduled under enhanced HIPC Initiative completion point terms, multilateral creditors, and private creditors, but excluding obligations to the IMF (Table 1).

II. ADJUSTERS

Net international reserves

15. The quantitative targets (floors) for net international reserves (NIR) will be adjusted:

- downward by the shortfall in external program aid less debt service payments (up to US$100 million), compared to the program baseline (Table 1);
- downward/upward for any revision made to the end-year figures corresponding to the previous year; and
- downward to accommodate higher external outlays because of natural disasters, up to US$20 million.

Net credit to central government

16. The quantitative targets (ceilings) for net credit to the central government (NCG) will be adjusted:

- upward by the shortfall in the MT value of external program aid receipts less debt service payments (up to the MT equivalent of US$100 million at exchange rates prevailing at the respective test dates), compared to the program baseline (Table 1);
- downward by privatization proceeds in excess of those envisaged in the program, unless these proceeds are deposited in the government's savings accounts abroad;
- downward (upward) for any increase (decrease) in domestic financing from the nonfinancial private sector; and
- upward to accommodate the higher locally-financed outlays because of natural disasters, up to the MT equivalent of US$20 million at exchange rates prevailing at the respective test dates.

Reserve money

17. The quantitative target (ceiling) for reserve money will be adjusted upward by the excess of the stock of currency in circulation above the level envisaged in the program. For programming purposes, both the stocks of reserve money and currency in circulation are defined in terms of the average of the daily end-of-day stocks in the month of the test date. The target will be adjusted up to MT 500 million for end-March, end-June, and end-September and up to MT 750 million for end-December (Table 1).

New nonconcessional external debt contracted or guaranteed by the central government, the BM, and selected state-owned enterprises, with maturity of more than one year

18. Should the signature of the Brazilian loans for the Nacala and Beira projects (US$80 and 220 million, respectively) be delayed from 2010 to 2011, the relevant AC ceiling for 2011 will be increased by the relevant shortfall.

III. Data and Other Reporting

19. The government will provide Fund staff with:

- monthly and quarterly data needed to monitor program implementation in relation to the program's quantitative targets and broader economic developments;
- weekly updates of the daily data set out in Table 1;
- weekly data set out in Table 4 of the TMU dated May 26, 2005;
- monthly updates of the foreign exchange cash flow of the BM;

- monthly data on government revenues (in detail according to the fiscal table) with a lag not exceeding one month;
- monthly information on the balance of government savings accounts abroad;
- monthly data on domestic arrears;
- monthly budget execution reports (that will also be published) with a time lag not exceeding 45 days;
- monthly monetary survey data with a time lag not exceeding 30 days; and
- monthly data on gross international reserves, with the composition by original currencies and converted to US dollars at the actual exchange rates.

19. The monetary survey made available by the BM will clearly identify donor-financed project deposits (with a breakdown between foreign and domestic currency) included in net credit to the government in both the central bank's and commercial banks' balance sheets.

20. The government will provide Fund staff with documentation concerning external loan agreements once these have been signed and become effective.

TMU Table 1. Mozambique: Net Foreign Assistance, 2010-11

	2010										2011	
	Q1		Q2		Q3		Q4		Year		Q1	Q2
	Prog.	Act.	Prog.	Act.	Prog.	Proj.	Prog.	Proj.	Prog.	Proj.	Proj.	Proj.
Net foreign program assistance (US$ mn)	163	57	181	151	27	74	145	115	424	396	129	106
Gross foreign program assistance	182	74	203	168	42	92	165	132	496	467	144	121
Program grants	151	74	176	139	42	92	55	50	359	355	144	89
Program loans	30	0	27	30	0	0	110	82	137	112	0	32
External debt service	18	18	22	18	15	18	20	18	71	71	15	15
Net foreign program assistance (MT mn)	4,843	1,706	5,378	4,581	829	2,673	4,582	3,975	12,781	12,935	4,732	3,838
Gross foreign program assistance	5,220	2,076	6,021	5,673	1,278	3,287	5,218	4,738	14,923	15,775	5,253	4,375
Program grants	4,344	2,076	5,229	4,659	1,278	3,287	1,741	1,798	10,655	11,821	5,253	3,229
Program loans	876	0	792	1,014	0	0	3,476	2,940	4,268	3,954	0	1,147
External debt service	376	370	643	1,092	449	614	636	763	2,142	2,840	521	537
Stock of outstanding currency (MTm)	13,278	14,515	16,445	16,721	16,436	18,372	19,222	19,134	19,222	19,134	16,098	17,556
Stock of outstanding currency (MTm), Prog. D	13,278	14,317	15,324	16,080	16,052	17,874	18,702	18,616	18,702	18,616	15,878	16,883

Source: Mozambican authorities and IMF staff estimates