International Monetary Fund

Republic of Mozambique and the IMF

Press Release:
IMF Executive Board Approves New Three-Year PSI, Completes Second Review Under the ESF Arrangement and Approves US$21 Million Disbursement for Mozambique
June 14, 2010

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

May 24, 2010

The following item is a Letter of Intent of the government of Republic of Mozambique, which describes the policies that Republic of Mozambique intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Republic of Mozambique, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

REPUBLIC OF MOZAMBIQUE: LETTER OF INTENT

May 24, 2010

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

Dear Mr. Strauss-Kahn:

The Government of Mozambique requests the completion of the sixth review under the Policy Support Instrument (PSI) and the second review under the Exogenous Shocks Facility (ESF). It also requests the approval of a successor PSI for 2010-13. 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 current PSI and sets out the government's objectives and policies over the short and medium term under the new program.

These policies are consistent with the government's medium-term *Plano de Acção para a Redução da Pobreza Absoluta II* (PARPA II) for 2006-09, which was extended to 2010. It aims to maintain macroeconomic stability, promote diversified and strong economic growth, and reduce poverty. A successor Poverty Reduction Strategy is expected to be approved in the second half of 2010, before the first review of the new PSI.

With respect to the current program, all quantitative assessment/performance criteria (A/PC) through end-December 2009 were met, except for the one on reserve money, for which we request a waiver. Reserve money exceeded the program ceiling because of the continued difficulty in predicting the demand for currency in circulation as a result of both the year-end seasonal surge and the structural shift from the expansion of banking services in the economy. 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 successor PSI-supported program. Given our dedication to macroeconomic stability, 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/

Manuel Chang
Minister of Finance

/s/

Ernesto Gouveia Gove
Governor
Bank of Mozambique

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

ATTACHMENT I

REPUBLIC OF MOZAMBIQUE: MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

May 24, 2010

I. PERFORMANCE UNDER THE PSI AND ESF ARRANGEMENT

1. Mozambique showed considerable resilience to the global economic crisis. Real GDP expanded by 6⅓ percent in 2009, much stronger than expected. Economic activity benefited from dynamic construction, energy, and financial sectors. However, the global crisis triggered large declines in export receipts and private external borrowing. The impact on external reserves was mitigated by the SDR allocation and ESF resources, resulting in an import reserve coverage above 5 months. The government eased macroeconomic policies to contain spillover effects of the crisis to the domestic economy. An accommodating monetary policy facilitated the substitution of foreign borrowing with an exceptionally strong private sector credit expansion. A strong revenue performance kept the size of the automatic stabilizers small and resulted in a lower-than-expected domestic primary fiscal deficit.

2. All the quantitative performance/assessment criteria (P/AC) were met through end-December 2009, except for the one on reserve money, for which we request a waiver. Base money exceeded the program ceiling because of the continued difficulty in predicting the demand for currency in circulation as a result of both the year-end seasonal surge and the structural shift arising from the expansion of banking services in the economy. Structural reforms are on track as well. Specifically, the Extractive Industry Transparency Initiative (EITI) secretariat was created at end-March 2010 and both benchmarks related to the Revenue Authority—the strengthening of its organizational structure and adoption of the *e-tax* Strategic Planning Document—are being implemented as planned. However, the financial sector contingency plan envisaged for end-May is likely going to be completed by end-September 2010, partly due to delays in the government's application for, and the World Bank's approval of, funding for the exercise.

II. OBJECTIVES AND POLICIES GOING FORWARD

A. Economic Objectives

3. The government takes pride in Mozambique's strong economic performance and successful policy implementation under successive IMF-supported programs. This enabled the country to preserve its sound economic fundamentals, with strong economic growth, single-digit inflation, a relatively comfortable international reserves position, and low external and public debt indicators. As a result, the government has gained some flexibility to ease macroeconomic policies to respond to exogenous shocks—such as the recent global crisis—and, going forward, to step up its economic development efforts.

4. Such efforts to sustainably raise and broaden the country's productive base are necessary, since Mozambique's economic growth, although high by regional standards, has been trending down over the last decade.

5. Going forward, the government's focus will be on policies to create an environment conducive to strong private sector activity, which is expected to also help ensure that more and more segments of the population will benefit from economic development. Specifically, the government considers the following avenues to be the most promising to help boost economic development: (i) maintaining macroeconomic stability; (ii) encouraging additional national and foreign direct investment in the natural resources export sector; (iii) significantly stepping up public investment in transport and electricity infrastructure, partly financed through nonconcessional external borrowing and/or Public-Private Partnerships (PPP); (iv) improving the business climate; and (v) reaping benefits from regional integration. In all these efforts, the government will closely cooperate with the domestic private sector and tap expertise from development partners.

6. Consistent with these objectives and policies, the government will update Mozambique's *Five-Year Government Program (PQG)* for 2010–14 and adopt it by mid-2010. The development plan will be supplemented by an updated Poverty Reduction Strategy, which will be drafted involving the private sector, civil society, and development partners, and finalized in the second half of 2010, before the first review under the PSI.

B. Macroeconomic Outlook

7. As the global economic crisis wanes, the economic outlook is expected to become more favorable. Real GDP growth should accelerate to 6½ percent in 2010 and 7¾ percent by 2013, largely because of new megaprojects, stepped-up public investment in areas with an expected large growth dividend, and larger private sector participation. Continued prudent macroeconomic policies should keep inflation at around 6 percent on average over the medium term, with a temporary spike in 2010 to above 9 percent following the gradual removal of the fuel subsidy. The government's investment plans should not fundamentally burden the current account and reserve levels; the current account (after grants) and international reserves are expected to hover around 14 percent of GDP and above five months of imports, respectively, over the next three years.

C. Macroeconomic Policy Mix

8. In 2010, the government intends to gradually unwind the temporary monetary and fiscal stimulus which helped Mozambique weather the impact of the global economic crisis. In particular, the Bank of Mozambique (BM) will begin to reverse, in tandem with the expected recovery of global credit markets, the sharp easing of monetary policy that facilitated substitution of foreign borrowing with domestic credit in the wake of the crisis in 2009. This should also help ward off potential inflationary pressures arising from the

recent exchange rate depreciation and from spillovers from the removal of the fuel subsidy, while sustaining credit quality. As to fiscal policy, the strength in revenue collections is expected to continue and should allow a full reversal of the automatic stabilizers and a moderate reduction in the primary domestic deficit relative to 2009.

9. Over the medium term, the government will adjust its macroeconomic policy mix to gradually and prudently increase public investment to close gaps in transport and electricity infrastructure and thus help raise the country's growth potential. To this end, the fiscal stance will be adjusted to make room for higher domestic and external borrowing, over a limited time horizon, to implement selected high-priority projects with an expected high economic return. Part of the external borrowing is expected to be on nonconcessional terms. Although this will worsen Mozambique's low debt indicators, the limited time horizon of the planned investment increase and our commitment to concentrate on investment projects with a high growth dividend should ensure that debt sustainability is not at risk.

10. The temporary time horizon of the surge in capital spending will be consistent with macroeconomic stability and debt sustainability. It is not expected to crowd out private investment nor create pressure on domestic demand, as labor markets are underutilized and the investments will have a high import component. In addition, the domestic primary fiscal deficit will remain moderate, and monetary policy will be appropriately tight to ward off inflationary pressures while supporting a continued financial deepening. Should domestic demand pressures materialize, the authorities stand ready to adjust macroeconomic policies accordingly.

D. Fiscal Policy

2010 budget implementation

11. The government aims to reduce the domestic primary deficit by ¼ percentage point, to 4.2 percent of GDP, in 2010. This mainly reflects our intention to further improve tax administration and contain current expenditure. While the 2010 budget law anticipates strong efficiency gains in tax administration that could boost the revenue-to-GDP ratio by 0.7 percentage point, to 18¾ percent of GDP, the government will base its budget execution on more conservative assumptions. As a result, the government will take the following measures to keep domestic current spending broadly unchanged in terms of GDP relative to 2009 until evidence of a stronger revenue performance materializes:

- In accordance with legal provision of the 2010 Budget Law (Article vii), the Council of Ministers approved the decree on the provisions regarding budget execution (*Delegação de Competência sobre a Execução do Orçamento*) on April 27, 2010. In addition, on May 18, 2010, the Minister of Finance issued the interministerial regulation (*Circular Ministerial*) providing the guidance for line ministries for budget execution and contingencies. This legal framework, which is consistent with the general Public Financial Management Law (SISTAFE 2002), limits budget execution to cautionary ceilings as long as revenue collections remain uncertain. According to those provisions, such ceilings are: (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. As a result, spending in those categories is currently envisaged to be MT 6.7 billion (2.2 percent of GDP) below appropriations in the 2010 budget law. The decision to spend beyond those ceilings will be taken by mid-November.

12. The government has initiated the phasing out of the fuel subsidy and aims to gradually restore market-based retail prices by the third quarter of 2010. The date of the full pass-through will depend on international price movements but will ultimately entail the unconstrained application of the existing monthly price adjustment formula. To ensure transparency, the government will explicitly show fuel subsidies in its budget documents. With a view to protecting vulnerable segments of the population, the government considers replacing the fuel subsidies with better targeted and more effective alternative measures benefiting those truly in need, in consultation with development partners.

Medium-term fiscal stance

13. The government aims to step up its investment in transport and electricity infrastructure while safeguarding macroeconomic stability. To this end, the medium-term fiscal stance envisages enhanced borrowing from domestic and external sources over a limited time horizon of five years, which would lead to a concomitant temporary rise in the overall fiscal deficit (after grants). During the same period, the government commits to preserve the domestic primary deficit at around 4 percent of GDP. This entails that the expected efficiency gains in revenue administration of 2 percent of GDP will be channeled toward enhancing domestic spending priorities, without any additional recourse to financing.

Stepping up investment

14. The focus of the central government's investment strategy will be in transport and electricity infrastructure. This is to ensure that the expected growth effect materializes and the scaling up is consistent with the macroeconomic framework. Priority will be given to projects that could have a catalytic effect on private investment. 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 below) will be in those sectors (**continuous structural benchmark**). The government is currently assessing the prioritization and sequencing of infrastructure investment projects and expects to complete this process by the time of the first program review. It expects that several of the key projects will enjoy financing and/or co-financing from development partners, while others could be developed under a concession or a Public-Private Partnership (PPP). For any projects chosen to be financed with nonconcessional resources, the government will share all project feasibility studies—including those from donors co-financing possible projects—with

Bank and Fund staff. Among the projects under evaluation by the government, the following specific projects enjoy the highest priority at present:

- The international airport of Nacala in Nampula province, which would play a pivotal role in developing the northern part of the country and in servicing a special economic zone;
- The rehabilitation of the port of Beira, which is strategically located between the northern and southern parts of the country and also serves Malawi and Zimbabwe, the landlocked neighboring countries;
- 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; and
- An expansion and/or rehabilitation of the road network, as currently only about one-third of Mozambique's road infrastructure is asphalted. Possible priority projects could include the completion of the transit corridor connecting the port of Beira with Zimbabwe, with the rehabilitation of the remaining section from Beira to Inchope (120 km); and the road between the provinces of Gaza and Maputo (170 km), which would connect areas with high potential for tourism and agriculture.

Borrowing strategy

15. The government aims to implement its stepped-up investment plans by tapping domestic and international financing. As a general principle, the government will aim to rely on the creation of fiscal space through a strengthening of revenue collections, grants, and concessional borrowing first before increasing domestic and external financing:

- *Domestic Financing.* The government will limit its annual recourse to domestic financing to less than 1 percent of GDP over the medium term. This is expected to avoid crowding out the private sector. For 2010, the ceiling on net credit to the government is set at MT -1743 million for end-June (indicating a net accumulation in deposits) and MT 933 million for end-December (quantitative AC); these levels largely reflect a drawdown of deposits related to the advance disbursement of World Bank budget support in late 2009. The government and the BM will enhance their coordination on cash flow management, so as to facilitate the BM's liquidity forecasting and monetary operations.
- *External financing.* Concessional donor funds will remain the prime sources of financing in the foreseeable future. Nonetheless, given the size of the planned investment push, the government intends to contract nonconcessional external borrowing of no more than US$900 million during the three-year program period,

averaging about 2½ percent of GDP per year. An annual borrowing profile for the program period will be defined by the time of the first program review when the planning of size, purpose and timing of our investment plans will have been firmed up. At this stage, the contracting or guaranteeing of nonconcessional external loans by the central government and key state-owned entities, including the Road Fund, for the investment projects in the infrastructure and energy sectors defined in the previous section will be limited to US$200 million for 2010 (continuous quantitative AC).

16. By end-November 2010, the government will finalize a comprehensive multi-year debt strategy. The preparation of the debt strategy will be supported by FSTAP technical support and closely coordinated with Bank and Fund staff, including during the drafting stage. Key elements of the strategy are expected to include steps to derive an annual borrowing profile and calendar, lengthen the maturity structure to help extend the domestic yield curve, develop the institutional framework of domestic financial markets, and identify possible external financing options (**structural benchmark**).

17. In the same vein, the government will continue to strengthen its debt management. The debt unit in the Ministry of Finance will benefit from the addition of qualified staff to facilitate the semi-annual production of a debt sustainability analysis (DSA); the first such analysis will be completed and published by end-September 2010 (**structural benchmark**). The addition of necessary technical expertise aims to help the government make informed decisions about borrowing options (such as choice of instruments, size, currency, and maturity) and the evaluation of possible risks (such as rollover, currency and interest rate risk). The debt unit will also benefit from technical advice from the IMF and World Bank and the creation of a debt management committee (DMC), which will provide technical and analytical support for the development of the macroeconomic framework and DSA; the DMC will comprise staff of the Ministries of Finance, Planning and Development, the BM, and other relevant institutions, as needed.

Priority social spending

18. The government recognizes the importance to protect priority social spending to help sustain progress toward meeting the MDGs, including especially with respect to reducing poverty. Such spending is defined consistently with the PARPA classification. Such spending averaged 17.3 percent of GDP during 2007-09, representing 62 percent of total expenditure. It will be raised to 19.1 percent of GDP in 2010, equivalent to about 62.3 percent of total spending. An indicative floor of such spending is incorporated in the program. The definition of priority spending will be aligned with the any revisions to the concept under the new *Five-Year Government Program (PQG)* and the successor poverty reduction strategy once they are finalized.

E. Fiscal Structural Reforms

Expanding budget coverage

19. While at present the fiscal stance is measured on a central government basis, the government will expeditiously work toward integrating the Road Fund, the water authority (FIPAG), and the electricity company (EDM) into the fiscal and debt analysis. To this end, by end-June 2010, the government, with technical advice by Fund staff, will develop a fiscal template that will consolidate the revenue, expenditure, and financing of the central government and those entities, in consultation with Fund staff. On this basis, the government will produce by end-August 2010 quarterly consolidated fiscal accounts beginning in 2008. The Law on Public Enterprises, as mentioned above, will further stipulate the reporting requirements of SOEs to the government. This will form a basis for further broadening budget coverage over time, which we will undertake supported by Fund technical advice.

Revenue effort

20. The government will strive to raise its revenue-to-GDP ratio by 1.5 percentage points during the program period. A quantitative indicative target will help monitor progress in this regard. Technical assistance has helped focus the reforms in the areas of tax administration and tax policy on the following key initiatives:

- *Rolling out the electronic tax system e-Tributação (e-tax):* Following the approval of the *e-Tributação* Strategic Planning document on May 15, 2010, the government will approve in 2010 a procedure manual on the collection of the corporate income tax as a pilot for the e-tax roll-out. The revenue authority has also defined a set of concrete actions aimed at strengthening tax collection and improving the business environment. This includes the introduction of online tax filing and the possibility to pay taxes via bank transfer.
- *Reinforcing large taxpayers unit (LTU):* The national coordination unit for large tax payers, responsible for planning and monitoring all large taxpayers in the country including megaprojects, will initiate its operations by end-June 2010.
- *Tax policy:* To create a level playing field and improve the business environment, the government will assess the recommendations of the recent Fund technical assistance mission by the time of the first program review. As a first step, the government will create the legal basis for the tax treatment of new financial instruments, including mutual funds, leasing, and securitized loans.

Wage policy

21. The government will continue implementing a reform of the civil service pay scale. It approved a new salary policy in September 2008 that it will phase in over the medium term in a very gradual manner, in line with the need to preserve macroeconomic stability and fiscal sustainability. This gradual approach will stabilize the wage bill below 9¼ percent of

GDP over the medium term. The new policy aims to simplify and rationalize the salary scales across ministries, decompress the scales consistent with qualification and responsibility, reform the system of housing and other allowances, and harmonize the salary policy with the pension system. Further technical work, supported by development partners, will be undertaken in 2010 to help determine specific elements and the sequencing of reform steps.

Strengthening public financial management (PFM)

22. Based on the PFM vision paper and the 2010–12 *SISTAFE Action Plan and Budget*, the government envisages the following key measures in the short run:

- *Continued implementation of SISTAFE system:* e-SISTAFE will be further rolled out to 15 districts and 35 institutions. Budget execution through e-SISTAFE will gradually increase to 37.5 percent of the executed budget by end-2010. Its program classifiers will be further developed consistent with sectoral accounting, planning and reporting needs.

- *Rolling out e-FOLHA:* In order to increase coverage of the e-SISTAFE, by end-September 2010 the salary calculation and processing functionality will be rolled out to 8 sectors at the central level and to the City and Province of Maputo for a gradual introduction of direct salary payments into bank accounts.

- *Improved integration of internal audit in e-SISTAFE system:* The General Inspectorate of Finance (IGF) will move toward risk-based audits in light of the gradual roll-out of e-SISTAFE. To this end, IGF will issue a circular to financial departments of line ministries by September 2010 specifying that internal audit will be based on electronic e-SISTAFE reports wherever the system is used. In addition, to reflect emerging fiscal risks from the stepping up of infrastructure investments, IGF will reinforce its work program on state owned enterprises and PPPs.

- *Improving aid management:* The MF will actively encourage donors to use the single- and multi-currency treasury accounts at the BM for disbursing project aid.

- *Reinforcing investment planning, limiting fiscal and quasi-fiscal risks, and maximizing economic benefits:* By end-September 2010, the Council of Ministers will adopt a PPP Law, which will also be applicable to mega projects and other concessions, including those in the power generation area (**structural benchmark**). The law will include the creation of the PPP unit within the Ministry of Finance and the mechanisms to formalize the PPP approval process. It will also introduce 'gateway' decision points where the consensus of the Ministry of Finance would be required before the PPP can proceed, so as to manage risks. Implementation of the new framework will be facilitated by the creation of the new PPP unit in the Ministry of Finance to support the gateway process and improve financial oversight of PPPs, including through mandated regular reporting from PPPs on their financial statements to the PPP unit. The unit should be operational by end-2010.

- *Improving the framework for public enterprises*: A Public Enterprises Law will be adopted by the Council of Ministers by end-July 2010. Among other things, it will ringfence commercial activities of state-owned entities and require quarterly financial reporting to the Ministry of Finance and an annual tabulation of financial and other assets to the General State Accounts. It will also reaffirm the existing provisions that have limited contingent liabilities emanating from state-owned entities, including the need to obtain approval by the Minister of Finance for all borrowing.
- *Enhancing procurement systems:* Following up on the *Country Procurement Assessment Report* (CPAR), the government will adopt terms of reference for carrying out procurement audits in order to assess the integrity and transparency of the system. The ministries that are to be audited in 2011 will be selected by December 2010. By end-June 2010, a strategy for training and capacity development will be defined, and by end-December 2010, the terms of reference for the development of a career in government procurement and certification of experts in this area will be formulated.

Reforming the National Institute for Social Security (INSS)

23. To limit fiscal risks and improve governance and transparency, the government is reassessing its approach to reform the INSS. The adoption of a new investment strategy has been delayed, pending further necessary conceptual work supported by World Bank technical assistance. The new investment strategy will aim solely at protecting the interest of the beneficiaries of the social security system and be approved by end-June 2010. The INSS will also: (i) publish its audited financial statements of 2008 by end-August 2010 and of 2009 by end-2010; (ii) assess its financial viability based on an updated actuarial study that takes into account the financial statements through 2007, and by-end 2010 initiate corrective actions to guarantee the financial equilibrium of the INSS, to be implemented by INSS or to be submitted to the Council of Ministers; (iii) adopt its new organizational structure by end-October 2010; and (iv) introduce an IT system during 2010 to help improve registration of contributors and claimants and strengthen collection of contributions.

Enhancing governance in the natural resources sector

24. The government is committed to becoming a full member of EITI within the envisaged timeframe of two years, i.e., by May 2011. This will enhance the contribution of the natural resource sector to economic development as a result of the improved transparency and accountability in the sector. The newly created EITI secretariat will launch a dedicated EITI website by end July 2010, produce and distribute relevant brochures on EITI by end-July 2010, elaborate the terms of reference for the EITI auditor by end September 2010, and appoint the qualified EITI auditor by end November 2010.

F. Monetary and Exchange Rate Policies

25. The BM is committed to prudent monetary and exchange rate policies aimed at containing inflation at around 6 percent on average over the medium term. The monetary expansion consistent with this objective is expected to leave room for private sector credit expansion.

26. 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. This should allow the exchange rate to adjust freely to evolving patterns of trade and financial flows while safeguarding Mozambique's international reserves. The BM will continue to be cautious in managing the country's reserves in light of increasing external obligations.

27. The BM will decide whether to move to an inflation targeting framework over the next two years. Supported by IMF technical assistance, the BM is working on establishing the prerequisites for a successful transition, as outlined in the relevant action plan. Specifically, the BM will: (i) assess which inflation rate should be targeted and what core inflation rate should be used to assess inflationary conditions; (ii) enhance its monitoring, understanding, and capacity to project the monetary transmission mechanism; (iii) adopt and implement new monetary instruments to steer monetary conditions effectively; and (iv) improve its communications strategy with the public.

28. During the interim period, the BM will continue its reserve money targeting. A particular challenge will continue to be the structural shifts and seasonal surges in the demand for currency. To this end, the BM will:

- *Improve reserve money targeting.* Such targeting will be based on monthly averages, which will neutralize the spike in cash during the last two weeks of each month; and

- *Further enhance liquidity and foreign exchange management.* The BM will enhance coordination with the Ministry of Finance on domestic and external borrowing plans, aid management, and cash flow projections, as well as with banks on their liquidity requirements, as the potentially significant increase in foreign exchange inflows from the government's borrowing plans is likely to accentuate the BM's liquidity and foreign exchange management challenges.

29. The government intends to accept the obligations under Article VIII sections 2, 3, and 4 of the Fund's Articles of Agreement in due course. The official communication will be sent as soon as the implementation regulation has been brought in line with the new legislative framework that came into effect on March 11, 2009.

G. Financial Sector Policies

30. The government and the BM will ensure expeditious follow-up to the recommendations of the 2009 Financial Sector Assessment Program (FSAP) update and recent technical assistance:

- *Developing Financial Sector Action Plan.* After some delay, the interagency task force will promptly finalize an action plan to implement the FSAP recommendations by end-July 2010. The plan will include measures to enhance access to finance and financial market development, strengthen compliance of the supervisory framework with Basel Core Principles, and complete the modernization of the payments system.
- *Stepping up risk management*: In line with FSAP recommendations, the BM will issue regulation (Aviso) on risk management by end-December 2010. The government is working on a draft decree on deposit insurance which it intends to issue by year-end.
- *Enhancing supervision of banking system.* Following the rapid credit growth over the last two years, the BM will closely supervise activities in the banking system and encourage banks to develop a stress testing framework. Close attention will be devoted to assessing liquidity conditions and the quality of loan portfolios.
- *Fighting money laundering and financial crime:* Following the Inter-Ministerial Civil Service Committee's approval in April 2010 to hire new staff, the *Gabinete de Informação Financeira*—GIFIM (Financial Intelligence Unit) will immediately launch the recruitment process and proceed with the necessary capacity building, supported by development partners. The draft amendment to the 2002 AML law, which will remove incompatibilities between the law establishing the GIFIM and the AML law, will be submitted to Parliament by end-August 2010.

H. Other Structural Policies

31. The government is intensifying its reforms to improve the business environment to help raise Mozambique's growth potential, diversify exports, and stimulate new investment. In coordination with the World Bank, it will work toward implementing a range of fast-track measures by end-2010. This is expected to ease red tape, streamline the granting of business-related licenses, improve bankruptcy proceedings, and facilitate trading across borders.

32. The Government aims to improve its statistical data compilation and dissemination. This should facilitate migration to the Special Data Dissemination System (SDDS) in due course. The Government will focus on improving data quality related to the quarterly national accounts, consumer prices index, government finance statistics, and megaprojects, consistent with IMF technical assistance advice. In particular, the INE will choose a new calculating software before the new rebased Maputo CPI is launched in 2011; this will

remove the possible bias of the CPI. INE also intends to increase the geographic coverage of the CPI by including the Greater Maputo area and the populous province of Zambezia.

III. Program Monitoring

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

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

	2009			2010			
	End-Dec Performance/Assessment Criteria			End-March Indicative Target	End-June Assessment Criteria	End-Sept Indicative Target	End-Dec Assessment Criteria
	Prog.	Adj. Prog.	Prel. Est.	Prog.	Prog.	Prog.	Prog.
Assessment/Performance Criteria for end-June/December							
Net credit to the government (cumulative ceiling) 2/	2,148	2,494	790	-124	-1,743	868	933
Stock of reserve money (ceiling)	22,685	23,685	24,464	21,031	24,567	25,753	28,173
Stock of net international reserves of the BM (floor, US$ millions)	1,758	1,725	1,834	1,711	1,759	1,885	1,930
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)	5	5	5	5	200	200	200
Stock of short-term external public debt outstanding (ceiling)	0	0	0	0	0	0	0
External payments arrears (ceiling)	0	0	0	0	0	0	0
Indicative targets:							
Government revenue (cumulative floor)	42,553	42,553	46,733	10,810	27,049	41,732	56,474
Priority spending (cumulative floor)	...	...	...	...	...	43,562	58,424

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] From June 2010, this is average of the daily stock of reserve money and FDP in the third month of the quarter.

Table 2. Mozambique: Structural Benchmarks for Successor PSI

Mozambique: Structural Benchmarks for Successor PSI

Actions	Expected Date of Implementation
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 will be for transportation and electricity infrastructure investment, as described in paragraph 14 of the MEFP.	Continuous
Adoption by Council of Ministers of PPP, Concessions and Megaprojects Law, as described in paragraph 22 of the MEFP.	End-September 2010
Finalization of a comprehensive debt strategy that will assess the risk profile and the fiscal and macroeconomic implications of new borrowing, as described in paragraph 16 of the MEFP.	End-November 2010
Completion of first Government Debt Sustainability Analysis, as described in paragraph 17 of the MEFP.	End-September 2010

ATTACHMENT II

REPUBLIC OF MOZAMBIQUE: TECHNICAL MEMORANDUM OF UNDERSTANDING

May 24, 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 (33 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. The target is 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).

III. Data and Other Reporting

18. 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; 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, 2009-10

	2009				2010				
	Q4		Year		Q1	Q2	Q3	Q4	Year
	Prog.	Act.	Prog.	Act.	Prog.				
Net foreign program assistance (US$ mn)	127	128	446	421	71	181	27	145	424
Gross foreign program assistance	144	140	501	468	86	203	42	165	496
Program grants	34	30	361	327	86	176	42	55	359
Program loans	110	110	140	140	0	27	0	110	137
External debt service	17	12	56	46	15	22	15	20	71
World Bank PRSC 6 Disbursement	110	110	110	110	0	0	0	0	0
Net foreign program assistance (MT mn)	2,885	3,743	11,331	11,777	1,991	5,378	829	4,582	12,781
Gross foreign program assistance	3,895	4,062	13,270	12,923	2,406	6,021	1,278	5,218	14,923
Program grants	928	1,067	9,500	9,125	2,406	5,229	1,278	1,741	10,655
Program loans	2,967	2,996	3,770	3,798	0	792	0	3,476	4,268
External debt service	1,010	320	1,939	1,147	415	643	449	636	2,142
World Bank PRSC 6 Disbursement	2,697	2,769	2,697	2,769	0	0	0	0	0
Stock of outstanding currency (MTm)	15,004	16,117	15,004	16,117	14,057	16,445	16,436	19,222	19,222

Source: Mozambican authorities and IMF staff estimates