Republic of Mozambique and the IMF

Press Release:
IMF Executive Board Completes Fourth Review Under the Three-Year PRGF Arrangement for Mozambique
June 19, 2006

Country's Policy Intentions Documents

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

April 3, 2006

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.

Maputo, Mozambique
April 3, 2006

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. de Rato:

1. On behalf of the Government of Mozambique, we hereby transmit the attached memorandum of economic and financial policies (MEFP) that sets out the objectives and policies that the Government intends to implement in 2006, as well as the underlying macroeconomic policy framework consistent with the PARPA II. The attached revised technical memorandum of understanding (TMU) defines the terms and conditions of the program.

2. The Government of Mozambique continues to make progress in implementing the 2004-06 program supported by the three-year arrangement under the Poverty Reduction and Growth Facility (PRGF), which was approved by the Fund's Executive Board on July 6, 2004. All quantitative performance criteria at end-December 2005 were observed. However, we encountered some delay on the structural side. The program for 2006 and the medium term framework have been revised to take into account the multilateral debt relief initiative (MDRI), domestic and international economic developments, and PARPA II.

3. We would like to thank the IMF for the prompt implementation of the MDRI; part of the resources released has been incorporated in the execution of the 2006 budget. As discussed with the Fund staff during the third review mission, we will spend the additional resources made available by the MDRI on contingent poverty-reducing "priority" expenditures identified in the budget.

4. In support of its objectives and policies, the Government of Mozambique hereby requests the disbursement of the fifth loan under the PRGF in the amount of SDR 1.62 million (1.4 percent of quota) on the completion of the fourth review.

5. Looking ahead, the policies set out in the MEFP continue to aim to consolidate macroeconomic stability and sustain strong broad-based growth in order to continue to reduce poverty. The performance criteria and benchmarks for the fifth review will be based on the end-June 2006 and end-September 2006 targets as set out in Tables 1 and 3 of the

MEFP. The sixth review, which will make available the seventh disbursement, is expected to be completed by June 30, 2007, and will be based on the observance of the end-December 2006 performance criteria set forth in Table 1 and Table 3 of the MEFP. Additional conditionality for the seventh disbursement will be established at the time of the fifth review.

6. We request a modification of the performance criterion on the rollout of e-SISTAFE to the Ministries of Agriculture, Health, and Public Works at end-June 2006 due to technical delays related to the introduction of a new family of metical.

7. We request a modification of the nature of the quantitative performance criteria for end-June as set out in Table 1 and the TMU.

8. The Government of Mozambique intends to accept its obligations under Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement following the approval of the new foreign exchange law which will be submitted to the Assembly by end-September 2006.

9. The Government of Mozambique will provide the Fund with such information as the Fund may request in connection with the progress made in implementing the economic and financial policies and achieving the objectives of the program.

10. The Government of Mozambique believes that the policies and measures set forth in the MEFP are adequate to achieve the objectives of its economic program for 2006 supported by the PRGF arrangement, but it will take further measures to that end if deemed necessary. During the implementation of the arrangement, the Government of Mozambique will consult with the Managing Director on the adoption of these measures and in advance of revisions to the policies contained in the MEFP, at the initiative of the Government or whenever the Managing Director requests such a consultation.

Sincerely yours,

/ s /
Manuel Chang
Minister of Finance

/ s /
Adriano Afonso Maleiane
Governor
Bank of Mozambique

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

Memorandum of Economic and Financial Policies of the Government of Mozambique for the Fourth Review Under the PRGF Arrangement

April 3, 2006

1. The Government of Mozambique is committed to continue to consolidate macroeconomic stability and to achieve sustained economic growth and poverty reduction through the pursuit of prudent macroeconomic policies and structural reforms. The strategy to achieve these goals in 2006–09 is set out in the *Plano de Acção Para a Redução da Pobreza Absoluta II* (PARPA II) approved by the Government in April 2006. The Government's economic program is supported by the International Monetary Fund (IMF) with a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF), which was approved on July 6, 2004. This Memorandum of Economic and Financial Policies (MEFP) reviews the performance under the program (October 2005–March 2006) and describes the policies and targets for 2006.

I. Recent Performance Under the PRGF-Supported Program

2. In 2005, economic performance remained favorable. Real GDP growth is expected to have reached about 7½ percent in 2005 led by the construction and manufacturing sector, and by the continued contribution of megaprojects. The localized drought that affected parts of the country in 2005 has eased with good rainfall (and localized flooding) recently. However, about 800,000 people still live on food aid until the next harvest in April 2006. While the annual average headline inflation rate moderated from 12.6 percent in 2004 to 6.4 percent in 2005 driven by lower food prices, it accelerated in the last few months due to the spike in domestic petroleum prices and pass-through of the exchange rate depreciation in October-November 2005. In response to mounting exchange rate volatility, the BM temporarily introduced an exchange rate band in the interbank foreign exchange market in November 2005. The NIR target for end-December 2005 was met and most of the real effective appreciation of the metical in 2004 was reversed in 2005.

3. Fiscal performance for 2005 was better than programmed. The domestic primary deficit has narrowed by about 2 percent of GDP (about 1 percent better than programmed) compared to 2004 on account of higher domestic revenues and a lower level of current expenditures. The lower level of expenditures was a result of the delay in the adoption of the 2005 budget following the general election in December 2004.

4. Progress has been made in reforming revenue administration and widening the tax base. The general tax law and the law creating the Central Revenue Authority (ATM) were approved by the Assembly in December 2005, and promulgated in February 2006. The implementing regulations for the ATM law were prepared and are currently being discussed at the National Council of Public Function, to be approved by the Council of Ministers by

end-June 2006 (structural benchmark). The organic law of tax tribunals was also approved by the Government, paving the way to establish tax tribunals. In addition, the following measures were implemented: (i) identifying and collecting tax arrears related to the personal and corporate income taxes for 2003–04; (ii) increasing the number of taxpayers to 295,000; (iii) and conducting a larger number of tax audits.

5. Public Expenditure Management (PEM) reforms continue to move ahead, albeit with some delay. The pilot rollout of e-SISTAFE (Financial Administration System) to the Ministries of Education and Culture, Finance, and Planning was implemented in November 2005 but the disbursement of funds *(adiantamento de fundos)* were only partially eliminated (structural benchmark for end-December 2005). The full functionality of the system has been delayed until July 2006 due to difficulties in the development of the new version of the software (first version of Homoine software for e-SISTAFE). The 2006 budget and the current version of e-SISTAFE use an improved functional and "origin-of-resources" budget classifiers. As such, the capacity to track and report on “priority” poverty-reducing expenditures and the MDRI resources have been enhanced. In addition, off budget project expenditures financed by external aid are starting to be integrated gradually into the e-SISTAFE with the help of the donor community, including the World Bank.

6. Monetary policy has remained prudent. The performance criterion on Net Domestic Assets (NDA) and the indicative target on base money were met for end-December 2005 but broad money was higher than programmed due to greater than anticipated net foreign assets and stronger growth in credit to the economy. The recorded increase in credit to the economy was mainly related to the financing of large oil import transactions and the inclusion of the operations of a leasing company purchased by Banco Internacional de Moçambique (BIM) in the monetary survey since December.

7. Prudential ratios of the banking system have continued to improve. The ratio of non-performing loans to total loans has fallen below 5 percent as commercial banks have written off bad loans as part of their restructuring plans which are now largely complete. Since July 2005, commercial banks are required to provision 50 percent of their foreign currency-denominated loans to nonexporters. This has led to a deceleration in foreign currency loan growth but commercial banks have remained within their foreign currency exposure limits. Overall, the commercial banking system appears to be well capitalized and profitable. In addition, in order to strengthen the balance sheet of the BM, securities in an amount of MT 1.5 trillion were issued to BM in June 2005 as envisaged in the program.

8. Progress on other structural reforms in 2005 was slower than envisaged, particularly with regard to public sector reform, labor market reform, and public enterprises. The finalization of a draft law to increase labor market flexibility was delayed due to the time needed to build consensus among all stakeholders. In addition, the independent census of the

civil service found that the three databases of civil servants were not reconcilable and recommended the creation of an integrated payroll database system. The adoption of the revised anti-corruption strategy by the Council of Ministers was delayed by a month (a structural benchmark for end-March 2006). On a positive note, a decree establishing procurement regulations in line with international standards was adopted in December 2005, and the new Commercial Code, the Commercial Registration Code, and the Civil Procedure Code were approved in December 2005. Commercial sections in the Judicial Tribunals of the city of Maputo were also established along with Sofala and Nampula.

II. The Policy Agenda for 2006

9. The policy framework, which aims at consolidating macroeconomic stability, is consistent with the medium-term goal of sustaining poverty reduction through strong economic growth. The Government is committed to continue to implement measures to strengthen the transparency and monitoring of the budget execution including the MDRI resources, to fine-tune monetary policy, and to reinvigorate and accelerate the structural reform agenda. Furthermore, the Government intends to continue to monitor its program with the existing multi-disciplinary committee, particularly through reinforced coordination between the BM and the Ministry of Finance (MF).

10. Prospects for 2006 are for continued broad-based and strong economic growth, a containment of inflationary pressures stemming from external shocks, and the maintenance of a sustainable fiscal and external position. Real GDP growth is expected to pick-up slightly to 7.9 percent in 2006 as a result of the recovery in agricultural production, and continued strong growth in construction related to megaprojects activities. The impact of the spike in petroleum prices and exchange rate depreciation in the last few months is expected to increase the average headline inflation rate to 9.5 percent in 2006. Despite a further increase in the oil import bill expected in 2006, the external current account deficit, excluding grants, is projected to decrease, mainly on account of higher exports. Overall, NIR will remain above four months of imports goods and nonfactor services (and five months excluding mega projects imports).

11. The 2006 fiscal stance will reflect additional expenditures identified in the 2006 budget that were contingent on the MDRI. As such, expenditures will be higher by about 0.5 percent of GDP financed by MDRI relief from the Fund to increase poverty-reducing expenditures in “priority” sectors. The wage bill will remain at about 7.5 percent of GDP—despite the hiring of about 10,000 teachers as originally programmed. As a result, the domestic primary deficit will be 2.6 percent of GDP with a negative net domestic banking financing of 2.5 of GDP. The share of spending on priority sectors out of total primary expenditures will exceed 65 percent. Total domestic revenue is envisaged to rise by about 0.4 percent of GDP owing to the collection of tax arrears amounting to about 0.2 percent of

GDP, the quarterly adjustment of the tax rate on fuels which was not fully implemented in 2005, a broadening of the tax base through raising taxpayer registration by 100,000, and an improvement in tax administration.

12. In 2006, emphasis in the revenue area will be given to the following priorities: (i) continuing to modernize the tax administration by establishment of the ATM through the implementation of the strategic plan; (ii) strengthening auditing, inspection and enforcement procedures to minimize fraud and tax evasion, particularly for large taxpayers; (iii) upgrading the taxpayer information system and improving taxpayer services; (iv) installing electronic scanners at border points and reorganization of customs operations; and (iv) establishing tax tribunals in Maputo, Beira, and Nampula for domestic taxes (structural benchmark for end-June 2006).

13. During 2006, the Government will also intensify its efforts to improve public expenditure management through the continued implementation of SISTAFE. The Government will develop and test a new version of the e-SISTAFE (Homoine version) software to enable effective direct budget execution (according to the sequence of commitment, verification, and payment) for goods and services in the Ministries of Finance, Planning, Education, Agriculture, Health, and Public Works, at the central and provincial levels (a structural performance criterion) by end-July 2006. By end-December 2006, all budgetary operations for goods and services of Financial Management Departments (DAFs) of at least 22 additional ministries and organs (see attached list in the TMU), at the central and provincial levels, will be executed through the e-SISTAFE (structural benchmark) with the help of the international community. In addition, with the support of the donor community, off-budget project expenditures outside the Treasury Single Account will be progressively included in the e-SISTAFE and the multi-currency functionality will be ready by January 2007. The Government will continue to implement its fiscal decentralization strategy with due regard to sequencing, in particular the need to buttress local administrative capacity, procurement and financial reporting and auditing. The Government will complete a prioritized plan by end-September 2006 to gradually rollout e-SISTAFE to all districts (structural benchmark).

14. On monetary policy, the BM will continue to target base money with a view to achieving the inflation target for 2006. To achieve the inflation objective of 7 percent by end-2006, base money growth will be limited to 15 percent or slightly lower than nominal GDP growth. The complete removal of interest rate caps in the treasury-bill auctions (for all maturities) in March 2006 will make monetary policy more effective and provide a yield curve for pricing of financial services. All interest rates are now market-determined. In addition, the monetary authority remains committed to a flexible exchange rate regime which will help cushion against exogenous shocks and maintain a comfortable level of international reserves.

15. The BM is committed to monetary reforms. It will continue to improve its liquidity management framework by preparing quarterly, weekly, and daily liquidity forecasts, and by deepening debt markets as part of the Financial Sector Technical Assistance Program (FSTAP). The MF will also improve the preparation of daily, weekly, and monthly cash-flow projections and execution, and has requested technical assistance (TA) from the Fund in this area. Moreover, with World Bank technical assistance, the BM will finalize a master repurchase agreement by end-October 2006. With help from the Fund and the World Bank, the BM will develop a domestic debt strategy for monetary policy and market development. In this regard, BM and the MF will agree, through a memorandum of understanding, to shift the costs of managing monetary policy to the budget starting in 2008. To this effect, the MF will request technical assistance from the IMF. The BM is committed to analyzing alternatives to reduce the impact of the costs of required reserves on the spread between deposit and credit interest rates following best international practices. Finally, in order to conduct monetary policy in a more transparent manner, the BM, with Fund technical assistance, will adopt by end-December 2006 a Long-Term Monetary Policy Strategy, which will define the intermediate target compatible with the base money operational target, design a new format for the monetary policy committee, and specify its communication policy.

16. The BM will introduce a new family of metical on July 1, 2006 (1000 old family of metical will be equal to one new family of metical). The BM has already made the necessary preparations, including the arrangements of legal, accounting, information technology and operational nature. In addition, the launch of a public information campaign covering the entire the country is well underway. This will ensure a smooth conversion of Government and public bank accounts through an effective coordination with commercial banks.

17. The BM will also continue to strengthen and modernize its supervisory functions and accounting. In this regard, the new inspection manuals were finalized. A proposal on the new organizational structure of the banking supervision department consistent with the Integral Strengthening Plan for Banking Supervision is expected to be approved by end-December 2006. In the area of accounting, the BM will adjust its Chart of Accounts by end-September 2006 (structural benchmark) to allow for: (i) the valuation of foreign exchange gains/losses consistent with International Financial Reporting Standards (IFRS); and (ii) the preparation of BM's financial statements for 2005 in compliance with IFRS in parallel to the financial statement prepared under the current accounting standard.

18. The Government remains committed to strengthening the balance sheet of the BM. To this end, in line with articles 14 and 66 of the BM Act, the Government will issue securities at market interest rates. The first issuance of securities in an amount of Mt 1.5 trillion was effected in June 2005, the second issuance at market interest rates will take place no later than end-June 2006. The net financial position of the BM has improved considerably in the first semester of 2005, thanks largely to the depreciation of the metical.

19. The BM is implementing a timetable to adopt International Financial Reporting Standards (IFRS) in the banking system and strengthen loan classification and provisioning in line with international best practices. The BM will continue to move forward with the necessary training and other preparations with the aim of fully implementing IFRS in the BM and the banking system starting in 2007. The Chart of Accounts of the commercial banking system will be made consistent with IFRS by end-September 2006 (structural benchmark). Moreover, a new regulation on the assessment, classification and provisioning of credits as well as a regulation on integral risk management for credit institutions and finance companies are expected to be approved in early 2007.

20. The Government is committed to supporting the sound expansion of the non-bank financial sector. The BM will license and supervise microfinance deposit-taking institutions to facilitate enhanced access to finance by rural households and small-and-medium sized enterprises. The strengthening of the social security and supplementary pension system is also being undertaken as part of a new law on social protection, which is under preparation. As part of the pension reform, the restructuring of the National Social Security Fund (INSS) will be expedited to improve operations, investment performance, and governance. As such, guarantees of minimum benefits will be limited until a full actuarial study is completed in 2006 with a view to switching to a defined contributory system. The Government also plans to enhance the regulatory and supervisory framework for supplementary pensions and INSS together with the insurance sector, including by strengthening the capacity of the *Inspecção Geral de Seguros* (IGS), the industry regulator.

21. The BM is committed to implementing the remaining actions needed to address weaknesses identified in the context of the Fund's safeguards assessment mission conducted in June 2004. In particular, the electronic link of the monetary data to the balance sheet was implemented in November 2005. Progress is also being made in making the necessary adjustments so that the balances in the BM's accounting records match the balances confirmed by the correspondents and other third parties. The reconciliation of monetary data with audited financial statements and its review by the internal audit department will be completed by end-December 2006.

22. Regarding the foreign exchange system, a new foreign exchange law taking into account comments from all stakeholders and the Fund, will be submitted to the Assembly by end-September 2006. Following approval of the new law and issuance of related regulations, the authorities intend to accept their obligations under Article VIII sections 2, 3, and 4 of the Fund's Articles of Agreement.

23. The Government expects to further liberalize the trade regime during 2006. In January 2006, the maximum import tariff rate applicable to SADC trading partners was lowered from 25 to 20 percent, and the Government has submitted a legislative authorization

draft to the Assembly to extend this measure to all trading partners. In addition, the Government will proceed with bilateral free trade arrangements as recommended in the Action Matrix of the Diagnostic Trade Integration Study. In this context, it expects to sign a bilateral free trade agreement with Zambia in 2006, similar to the ones that were concluded with Zimbabwe and Malawi in 2005.

24. The Government looks forward to completing the buyback operation for its commercial debt by mid-2006 with the financial assistance of the World Bank and the Government of Norway. The Government recognizes the importance of reaching rescheduling agreements with all bilateral creditors in the context of the enhanced HIPC Initiative. It has intensified its discussions with all Paris Club and non-Paris Club creditors that have not yet delivered debt relief, and hopes that progress would be made in reaching agreements with its remaining Paris Club creditors (Portugal and Japan) as soon as possible. Despite Government's efforts, there has been no progress in the negotiations with several large non-Paris Club creditors (including, among others, Algeria, Libya, Iraq and Romania). In this regard, the Government looks forward to the continued support of the Bretton Woods Institutions.

25. The Government recognizes the importance of removing a number of obstacles to private sector development. In this regard, steps are being taken to (i) reduce the cost of doing business in Mozambique, particularly by addressing rigidities in the labor market and improving basic infrastructure. In addition, the Government remains committed to promoting good governance and transparency in the management of natural resources and megaprojects, improving the functioning of the judicial system, and reforming the civil service.

26. Regarding labor regulations, the delayed draft new labor law is expected to be submitted to the Assembly by end-September 2006. This law will increase labor market flexibility by addressing in particular retrenchment costs and facilitating contractual hiring.

27. The Government will continue to restructure and encourage private participation in public enterprises, particularly infrastructure services. The structural benchmark on deciding the strategic option for the restructuring of PETROMOC, the state-owned petroleum distributor, by end-March 2006 was not met but will be undertaken by mid-May 2006. The Government with the help of the World Bank will put in place measures to assist the state-owned electricity company (EDM) to improve performance, including through the operationalization of the regulator (CNELEC).

28. Improving governance remains a priority of the Government. The Government is considering following the Extractive Industries Transparency Initiative (EITI) principles with regard to management of natural resources. All new related agreements, in particular the future exploitation of coal, oil and natural gas as well as any expansion of related megaprojects will follow these principles.

29. In the context of the implementation of the Anti-Money Laundering Law, the Government is committed to creating a financial investigation unit by end-September 2006.

30. In the area of public sector reform, the review of Phase I of the public sector reform (2001–05) was completed in September 2005 and provided lessons for the design of Phase II (2006–11), particularly the need to clearly prioritize and achieve visible results early on. Based on the recommendations of the Phase I review, the Government has prepared a proposal for the Phase II, which is being discussed among all stakeholders. The proposal highlights the need to strengthen the decentralization process (with a focus on building capacity in the districts), greater integration among the various activities, and a better sequencing. The Phase II program, including a timetable, will be submitted to the Council of Ministers by end-June 2006. In this context, the timetable will be defined to include the completion of a strategy paper on decentralization. This strategy will propose, among other things, a clear legal, regulatory, and institutional framework for revenue raising and spending responsibilities of subnational units and monitoring of subnational fiscal operations. To improve payroll management the Government will develop a plan to implement an integrated payroll database compatible with e-SISTAFE by end-September 2006. This will also allow to clean up the database and arrive at a unique number of total civil servants that may identify possible inexistent workers.

31. The Government is making progress in reforming the judicial system. The Organic Law for Judicial Tribunals, and commercial sections in the Judicial Tribunals of the city of Maputo will be operational by end-June 2006 and in the provinces of Sofala and Nampula by end-September 2006. The Penal Procedure Code and the new Insolvency Law are expected to be approved by end-December 2006.

32. A decree on urban land use will be approved by the council of ministers by end-June 2006, so as to facilitate the reduction of costs and time involved in transactions. In addition, the Government remains committed to conducting a Poverty and Social Impact Analysis (PSIA) of urban land tenure regulations, with the help of the World Bank.

III. MEDIUM-TERM MACROECONOMIC POLICY

33. The Government's medium-term objectives and priorities are defined in the 2005–09 Five-Year Plan, which sets forth as the foremost priority the reduction of absolute poverty through policies that ensure macroeconomic stability, greater private investment, and sustainable economic growth. The authorities carried out the third annual report on the implementation of their PARPA, which, together with the Five-Year Plan, has been instrumental in the preparation of PARPA II covering the period 2006–09 that was approved by the Council of Ministers in April 2006. The PARPA II shows that Mozambique is on track to meet the MDGs on income poverty, infant and maternal mortality, and access to safe

drinking water. However, other areas, such as primary school enrollment, gender equality, and HIV/AIDS, call for a more effective use of additional donor support as well as an expansion in absorptive capacity.

34. The main macroeconomic objectives over the medium term are to maintain a rate of growth of about 7 percent and to continue to gradually reduce the inflation rate through the pursuit of prudent fiscal and monetary policies in the context of the flexible exchange rate system. The medium-term economic policies will focus on spurring export-led private sector growth, while maintaining debt sustainability. Central to this strategy will be a gradual consolidation of the fiscal position, in order to increase credit to the economy and to maintain a competitive exchange rate. On the basis of current net external financing projections, the domestic primary deficit is projected to decline gradually underpinned by an average increase in revenue of 0.5 percent of GDP per annum. On the other hand, if a scaling-up of external program support materializes it will be used to finance additional expenditures on "priority" sectors as long as there is a continued improvement in public expenditure management and macroeconomic stability is not compromised. To facilitate such a flexible approach, the Government intends to cost programs that will help achieve the MDGs with the help of the donors. The related expenditures would be included as contingent expenditures in the medium term expenditure framework.

35. The structural reform agenda articulated in the PARPA II includes the launching of a "second wave of reforms." The focus will be on increasing tax collection, strengthening public expenditure management and fiscal transparency, implementing an agricultural and rural development strategy, and reducing the cost of doing business including by reforming the judicial sector and strengthening the financial system. An additional emphasis will be put on accelerating the engines of growth by promoting human capital formation, infrastructure investments, and maximizing the net contribution of natural resources and megaprojects to the economy. With respect to the latter, the Government will continue to strengthen the transparency of natural resource management and exploitation, and ensure that the country benefits more from the activities of the megaprojects, including through the State budget.

IV. Program Monitoring

36. The semiannual quantitative performance criteria for end-June 2006 and end-December 2006, as well as the indicative targets that will be used to evaluate the implementation of the program for the remainder of 2006 are shown in Table 1 of this memorandum, with further definitions and explanations contained in the annexed Technical Memorandum of Understanding. In addition, the Government has specified in Table 3 a list of structural performance criteria and benchmarks for 2006.

37. The fiscal program reflecting the MDRI will be monitored through a ceiling on net domestic financing of the government (NCG) excluding changes in project deposits in the banking system as opposed to the domestic primary deficit as outlined in the technical memorandum of understanding (TMU) that has been changed accordingly. This would be simpler and avoid adding the difference between the above-the-line recorded expenditures and below-the-line financing including donor-funded projects to the fiscal target, which is required under the current procedure. The NCG ceiling will be fully adjusted for privatization proceeds but asymmetrically for external program aid and debt service. There will be no adjuster on both NCG and NIR for any excess of program aid (and any shortfall in external debt service). As such, contingent "priority" expenditures identified in the 2006 budget can be executed in the event of any excess in program aid and domestic revenues (and any shortfall in external debt service) compared with the program. However, the NCG ceiling will be adjusted upward (and NIR downward) by 100 percent of any shortfall in external program aid (up to a maximum of US$50 million) and any excess in external debt service payments. In addition, the indicative target on base money will replace Net Domestic Assets as a performance criterion because it is more closely linked to inflation in Mozambique. Finally, the indicative target on the wage bill will be discontinued as it was introduced in a post-conflict situation when there were concerns regarding a loss of fiscal control through a ballooning of the wage bill, which is not the case anymore. Moreover, the complexities of determining the optimal size of the public sector (e.g. hiring of teachers and nurses) to meet the MDGs calls for a more flexible approach but the Government will closely monitor the evolution of the wage bill to contain inflationary pressures and maintain fiscal sustainability.

38. The Government understands that its ability to request the disbursement of the sixth loan under the PRGF arrangement will be contingent upon the observance of the semiannual quantitative performance criteria for end-June 2006 set out in Table 1; and the completion of the fifth review under the program, which is expected to take place before end-December 2006. In reviewing developments under the program during the fifth review, particular attention will be paid to the implementation of measures aimed at broadening the tax base and rolling out the e-SISTAFE, contingency expenditures in the 2006 budget, monetary and financial sector reform, the buttressing of governance and the legal system, and improving the availability and dissemination of information on natural resource exploitation and megaprojects as well as their net contribution.

Table 1a. Mozambique: Quantitative Performance Criteria and Indicative Targets, 2005–06 (Defined during the Third Review under the PRGF Arrangement)
(In billions of meticais, unless otherwise specified)

	2005			2006		
	End-Dec. Perf. Criteria	End-Dec. Perf. Criteria	End-Dec. Perf. Criteria	End-Mar. Indicative Target	End-Mar. Indicative Target	End-Mar. Perf. Criteria
	Prog.	Adj.	Prel. Act.	Prog.	Adj.	Prel. Act.
Government domestic primary deficit (excluding bank recapitalization costs (ceiling) 1/ 2/ 3/ 4/	4,481	4,481	3,052	800	800	...
Stock of net dom. assets of Bank of Mozambique (BM) (ceiling) 1/ 5/ 6/ 7/	-13,218	-13,179	-15,409	-15,911	-15,883	-21,594
Stock of net international reserves of the BM (floor, in millions of U.S. dollars) 1/ 8/	900	898	944	979	978	1,160
New nonconcessional external debt contracted or guaranteed by the central government or the BM with maturity of more than one year (ceiling) 9/	0	0	0	0	...	...
Stock of short-term external public debt outstanding (ceiling) 9/ 10/	0	0	0	0	...	...
External payments arrears (ceiling) 3/ 9/ 11/	0	0	0	0	...	...
Balance of the government's savings account set up abroad with proceeds from the coal exploration contract (floor, in millions of U.S. dollars, indicative target)	99	99	99	99	99	99
Government revenue (floor, indicative target) 3/	21,090	21,090	21,418	5,357	5,357	...
Stock of reserve money (ceiling, indicative target) 7/	12,205	12,205	12,153	11,678	11,678	11,802
Wage bill (ceiling, indicative target) 3/	11,045	11,045	10,358	2,909	2,909	...
Memorandum items:						
Foreign program assistance; grants and loans (in millions of U.S. dollars) 3/	292	...	292	159	...	159
Actual external debt service payments (in millions of U.S. dollars) 3/	68	...	70	12	...	13
Net flows	223	...	222	147	...	146
Exchange rate (meticais per U.S. dollar; end of period)	25,476	...	24,076	25,640		27,074
Shortfall in required reserves	...	...	...	...	...	...
Adjustment to BM's net domestic assets at program exch. rates	...	39	...	...	28	...
Adjustment to BM's NDA target	...	39	...	...	28	...
Adjustment to reserve money	...	0	...	...	0	...
Adjustment to BM's NDA due to shortfall/excess of net program assistance	...	39	...	...	28	...
Stock adjustments in medium- and long-term foreign liabilities	...	0	...	...	0	...

1/ Constitute quantitative performance criteria for end-December 2005.
2/ Defined as revenue minus noninterest current expenditure minus locally financed capital expenditure and locally financed net lending; to be measured from below the line based on financing items.
3/ Cumulative from the beginning of the calendar year.
4/ To be adjusted upward for up to Mt 400 billion in 2005 and Mt500 billion in 2006 to accommodate higher-than-budgeted locally financed drought-related expenditures. To be adjusted upward by any shortfall in debt service payments (including obligations to the IMF) in 2006 attributable to the implementation of the new multilateral debt cancellation initiative.
5/ Defined as reserve money minus net foreign assets (NFA) of the BM. NFA are valued at program exchange rates; NFA are defined to exclude the effect of any used stock adjustments in medium- and long-term liabilities.
6/ To be adjusted upward/downward to the extent of any shortfall/excess in foreign program assistance valued at program exchange rates and to be adjusted downward/upward to the extent that actual payments of external debt service exceed/fall short of programmed amounts (except for any debt service payments shortfall related to the multilateral debt cancellation initiative) . To be adjusted upwards for up to Mt 400 billion in 2005 and Mt 500 billion in 2006 to accommodate higher-than-budgeted locally financed drought-related expenditures.
7/ To be adjusted downward to the extent that eligible bank reserves fall short of 11.51 percent of deposits in commercial banks at the end of each quarter.
8/ To be adjusted downward/upward to the extent of any shortfall/excess of foreign program assistance relative to the programmed amount and to be adjusted upward/downward to the extent that actual payments of external debt service fall short of/exceed programmed amounts (except for any debt service payments shortfall related to the multilateral debt cancellation initiative). To be adjusted upwards for up to Mt 400 billion in 2005 and Mt 500 billion in 2006 (or the equivalent amount in U.S. dollars at the program exchange rate) to accommodate higher-than-budgeted locally financed drought-related expenditures.
9/ Continuous performance criterion.
10/ Loans of zero to one year's maturity, excluding normal import-related credits converted in U.S. dollars at actual exchange rates.
11/ Excluding arrears arising from debt-service payments that become due pending the conclusion of debt-rescheduling agreements.

Table 1b. Mozambique: Quantitative Performance Criteria and Indicative Targets, 2006 1/
(In billions of meticais; unless otherwise specified)

	2006		
	End-June Perf. Criteria	End-Sep. Indicative Target	End-Dec. Perf. Criteria
	Rev. Prog.	Rev. Prog.	Rev. Prog.
Net claims on the central government (cumulative ceiling)	-3,800	-4,300	-4,518
Stock of base money (ceiling)	12,033	13,209	14,038
Stock of net international reserves of the BM (floor, in millions of U.S. dollars)	1,097	1,073	1,063
New nonconcessional external debt contracted or guaranteed by the central government or the BM with maturity of more than one year (ceiling)	0	0	0
Stock of short-term external public debt outstanding (ceiling)	0	0	0
External payments arrears (ceiling)	0	0	0
Indicative targets:			
Balance of the government's savings account set up abroad with proceeds from the coal exploration contract (floor, in millions of U.S. dollars)	83	83	83
Government revenue (floor)	11,232	18,314	26,052

1/ For definition and adjustors see the attached Program Monitoring Section of Memorandum of Economic and Financial Polices and the Technical Memorandum of Understanding.

Table 2. Mozambique: Structural Performance Criterion and Benchmarks Under the 2005 and 2006 PRGF-Supported Program (October 2005–March 2006)

Actions	Expected Date of Implementation, According to the Program	Comments
Structural performance criterion		
All stages of expenditure (commitment, liquidation, payment, accounting, and reporting) at the Ministries of Agriculture, Health, and Public Works will be executed through the e-SISTAFE, at the central and provincial levels.	End-June 2006	Modified.
Structural benchmarks		
Rollout the SISTAFE to the MEC and abolish the disbursement of funds (adiantamento de fundos).	End-December 2005	Not Met.
A decision will be made on the strategic option for the restructuring of PETROMOC, the state-owned petroleum distributor.	End-March 2006	Not Met. Delayed to May 2006.
The approval of the revised anti-corruption strategy by the Council of Ministers.	End-March 2006	Not Met. Implemented in April 2006.
Establish tax tribunals in Maputo, Beira, and Nampula for domestic taxes.	End-June 2006	On Track

Table 3. Mozambique: Structural Performance Criterion and Benchmarks Under the 2006 PRGF-Supported Program (April–December 2006)

Actions	Expected Date of Implementation, According to the Program	Comments
Structural performance criterion		
The Government will develop and test a new version of the e-SISTAFE software (Homoine version) to enable effective direct budget execution (according to the sequence of commitment, verification, and payment) in the Ministries of Finance, Planning, Education, Agriculture, Health, and Public Works, at the central and provincial levels.	End-July 2006	
Structural benchmarks		
The implementing regulations for the ATM law will be approved by the Council of Ministers.	End-June 2006	
All budgetary operations for goods and services of Financial Management Departments (DAFs) of at least 22 additional ministries and organs (see attached list in the TMU), at the central and provincial levels, will be executed through the e-SISTAFE.	End-December 2006	
The Government will complete a prioritized plan to gradually rollout e-SISTAFE to all districts.	End-September 2006	
Establish tax tribunals in Maputo, Beira, and Nampula for domestic taxes.	End-June 2006	
Adjustments to the BM's Chart of Account will be approved.	End-September 2006	
The Chart of Accounts of commercial banks will be made consistent with IFRS.	End-September 2006	

Technical Memorandum of Understanding on Selected Concepts, Definitions, and Data Reporting Under Mozambique's PRGF-Supported Program

April 3, 2006

1. This technical memorandum of understanding (TMU) applies from January 1, 2006. Its purpose is to describe the concepts and definitions that will be used in monitoring the Poverty Reduction and Growth Facility (PRGF)-supported program, including the following:

- net claims on the central government by the banking system;
- government revenue;
- net international reserves, and reserve money of the Bank of Mozambique;
- new nonconcessional external debt contracted or guaranteed by the central government or the Bank of Mozambique with a maturity of more than one year;
- short-term external public debt outstanding;
- external payments arrears; and
- foreign program assistance and external debt service.

This memorandum also describes the adjusters that will be applied to certain quantitative performance criteria of the program.

Net Claims on the Central Government by the Banking System

2. **Net claims on 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 and proceeds from the signing fee for coal exploration. Credits comprise bank loans and advances to the government and holdings of 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 net claims on the central government by the banking system will be cumulative beginning end-December 2005 for the 2006 program.

3. The 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 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 Domestic Tax Administration (Administração Tributaria de Impostos or DGI), the National Directorate of Customs (Direcção Nacional de Alfândegas, DNA), 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 DGI from private agents or other government collecting agencies, in cash or checks, or through transfers into a DGI bank account.

6. An indicative target consisting of semiannual floors on the resources in the government's savings fund abroad has been added to monitor the use of the proceeds from the signing fee for coal exploration.

Money supply

7. **Base money** is defined as the sum of currency issued by Bank of Mozambique (BM) and the commercial banks' deposits in the BM. The commercial bank deposits include the statutory required reserves and excess reserves held at the BM. The base money ceilings for 2006 will be the total stock of base money outstanding at end-June 2006, end-September 2006 and end-December 2006, and will be monitored by the monetary authority and provided to the IMF by the BM.

Net international reserves

8. **Net international reserves** of the Bank of Mozambique are defined as reserve assets minus reserve liabilities. The Bank of Mozambique'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 government's savings account related to the Moatize coal mine concession). 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 Bank of Mozambique'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.

9. The Bank of Mozambique will publish the exchange rates quoted by commercial banks on average as the market rates.

New nonconcessional external debt contracted or guaranteed by the central government or the Bank of Mozambique with maturity of more than one year

10. The term "debt" will have the meaning set forth in Point 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted on August 24, 2000. Government debt is outstanding debt owed or guaranteed by the central government or the Bank of Mozambique (but does not include debt of any political subdivision or government-owned entity with a separate legal personality that is not otherwise owed or guaranteed by the central government).

11. The central government will not contract or guarantee external debt with original maturity of one year or more with a grant element of less than 35 percent, calculated using currency-specific discount rates based on the Organization for Economic Cooperation and Development (OECD) commercial interest reference rates. This performance criterion applies not only to debt as defined in point 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted on August 24, 2000, but also to commitments contracted or guaranteed for which value has not been received. This performance criterion will be assessed on a continuous basis.

Stock of short-term external public debt outstanding

12. The central government will not contract or guarantee external debt with original maturity of less than one year. This performance criterion applies not only to debt as defined in point 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted on August 24, 2000, but also to commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are short-term, import-related trade credits. This performance criterion will be assessed on a continuous basis.

External payments arrears

13. 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, including Paris Club creditors. This performance criterion will be assessed on a continuous basis.

Foreign program assistance

14. Foreign program assistance is defined as grants and loans received by the Ministry of Finance through Bank of Mozambique accounts excluding those related to projects (Tables 1).

Actual external debt-service payments

15. 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).

Adjusters

16. The quantitative targets (floors) for the central bank's net international reserves will not be adjusted for any excess in disbursements of foreign program assistance (and any shortfall in external debt service), compared to the program baseline. These targets will be adjusted downward by 100 percent of any shortfall in external program aid (up to a maximum of US$50 million) and any excess in external debt service payments, compared to

the program baseline (Table 1). The quantitative targets (floors) for the central bank's net international reserves will be adjusted downward/upward for any revision made to the end-year figures corresponding to the previous year. They will also be adjusted upward for the full amount of any external privatization proceeds in excess of those envisaged in the program, unless these proceeds are deposited in the government's savings account abroad. If they are deposited abroad, the indicative targets on the balance in this account will be adjusted upward for the full amount of the higher than envisaged proceeds, net of any costs related to the privatizations, including severance payments. The quantitative targets (floors) for the central bank's net international reserves will be adjusted equivalently downward up to a maximum of US$50 million per annum by the amount that the projected fuel import bill is higher due to a rise in the average global oil price (average petroleum spot price of West Texas Intermediate, U.K. Brent, and Dubai Fateh crude). This adjustment will be equal to the difference between the realized and the projected average global oil price, multiplied by the volume of total fuel imports projected for each quarter (Table 2).

17. The quantitative targets (ceilings) for net claims on the central government (NCG) will not be adjusted for any excess in disbursements of foreign program assistance (and any shortfall in external debt service), compared to the program baseline. These targets will be adjusted upward by 100 percent of any shortfall in external program aid (up to a maximum of US$50 million) and any excess in external debt service payments, compared to the program baseline (Table 1). These targets will also be adjusted downward for the full amount of any privatization proceeds in excess of those envisaged in the program, unless these proceeds are deposited in the government's savings account abroad. The government expenditures contingent on higher disbursements of foreign program assistance (and lower external debt service) will be used to finance greater "priority" spending identified in the budget.

18. The quantitative target (ceiling) for net claims on the central government (NCG) for end-June 2006 and end-December 2006 will be adjusted upward (and the floors on net international reserves adjusted downward) to accommodate the possible need for higher locally financed government outlays to deal with a drought, up to a total limit of Mt 500 billion.

19. The base money ceiling will be adjusted equivalently upward up to a maximum of Mt 250 billion at end-June 2006, end-September 2006, and end-December 2006 to the extent that the outstanding stock of currency issued by the BM exceeds those projected in Table 3.

Data reporting

20. In addition to providing the monthly and quarterly data needed to monitor program implementation in relation to the programs' quantitative targets and broader economic developments, the authorities will provide weekly updates of the daily data set out in Table 3 as well as the weekly data set out in Table 4 of the TMU dated May 26, 2005. Monthly updates will also be provided of the foreign exchange cash flow of the Bank of Mozambique.

21. The government will continue to provide Fund staff with the data corresponding to monthly government revenues (in detail according to the fiscal table), with a lag not exceeding one month. In addition, the government will continue to publish and provide Fund staff with the quarterly budget execution reports with a time lag not exceeding 45 days.

22. In addition, the government will provide monthly information on the balance of its savings account abroad and will start developing and providing information on domestic arrears on a quarterly basis.

23. From December 2005 onwards, the monetary survey made available by the Bank of Mozambique 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.

Table 1 Mozambique: Foreign Program Assistance and External Debt Service for 2006

(In Billions of meticais)

	2006				
	Q1 Prel Est.	Q2 Prog.	Q3 Prog.	Q4 Prog.	Year Prog.
Foreign program assistance	3978.7	1361.6	1932.1	635.9	7908.2
Program grants	2475.8	1361.6	1151.6	635.9	5624.8
Program loans	1502.9	0.0	780.5	0.0	2283.4
External debt service	307.4	393.2	325.2	435.7	1461.6

Source: Mozambican authorities; and Fund staff estimates.

Table 2: Projected Fuel Import Bill
(In millions of U.S. dollars, unless otherwise indicated)

Quarter	End-June 2006	End-September 2006	End-December 2006
Fuel import bill	92.7	58.5	124.5
Forecasted Oil price (US$ per barrel)	60.0	61.5	62.5
Volume of fuel imports (in metric tons)	160,147	101,814	185,431

Source: Mozambican authorities; and Fund staff projections.

Table 3: Currency Issued by the BM
(In billions of meticais, stock)

Quarter	End-June 2006	End-Sept 2006	End-Dec 2006
Currency issued by BM	6754	7938	8478

Source: Mozambican authorities; and Fund staff projections.

SISTAFE Implementation Plan

Action	Expected date
Implementation of Homoine in 6 sectors: 1. (MEC) Ministry of education and culture; 2. (MF) Ministry of Finance; 3. (MPD) Ministry of Planning and development; 4. (MISAU) Ministry of Health; 5. (MINAG) Ministry of Agriculture and, 6. (MOPH) Ministry of Public Works. All at Central and Provincial level, thereby gradually abolishing disbursement of funds by introducing direct budget execution and not including the external component.	31st of July 2006
Priorities for roll-out to Districts to be defined and elaborated	31st of September 2006
Rollout to the following Ministries and Organs: 1. (MAE) Ministry of Home affairs; 2. (MI) Ministry of Interior 3. (MD) Ministry of Defense 4. (MTS) Ministry of Technology and Science 5. Presidency of the Republic 6. Assembly of the Republic 7. Office of the Prime Minister 8. Conselho Superior da Magistratura 9. Casa Militar 10. Tribunal Administrativo 11. Conselho Constitucional 12. Tribunal Supremo 13. Procuradoria Geral da República 14. (MIC) Ministry of Industry and Commerce; 15. (ME) Ministry of Energy 16. (MRN) Ministry of Natural Resources 17. (MICOA) Ministry of Environmental Coordination 18. (MITUR) Ministry of Tourism 19. (MTC) Ministry of Transport and Communication 20. (MP) Ministry of Fishery 21. (MM) Ministry of Woman and Social Action 22. (MJ) Ministry of Justice	31st of December 2006