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

October 24, 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  
October 24, 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 the remainder of 2006 and 2007, 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-June 2006 and the structural performance criterion through end-July 2006 were achieved. The program for the remainder of 2006 is broadly unchanged while the 2007 and the medium term framework have been revised to take into account the 2007 budget, a scaling-up of foreign aid, domestic and international economic developments, and *Plano de Acção Para a Redução da Pobreza Absoluta II* (PARPA II).

3. The resources released as part of the MDRI have been incorporated in the execution of the 2006 budget and included in the medium term fiscal framework (MTFF) to be spent on poverty-reducing "priority" expenditures identified in the PARPA II.

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

5. Looking ahead, the policies set out in the MEFP continue to aim to consolidate macroeconomic stability and sustain strong broad-based growth through a second wave of reforms in order to achieve the Millennium Development Goals (MDGs). The performance criteria and benchmarks for the sixth and final review under the PRGF arrangement will be based on the end-December 2006, and through end-April 2007 targets as set out in Tables 1 and 3 of the MEFP. While the current PRGF arrangement expires in July 2007, indicative targets for end-June 2007, end-September 2007 and end-December 2007 are also set forth in Table 1.

6. 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-March 2007. The delay in the submission of the new draft foreign exchange law to the Assembly is related to the need to build a consensus among all stakeholders. The government remains committed to a flexible exchange rate regime.

7. 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.

8. 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 and 2007 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.

9. The government of Mozambique is considering the possibility to request a Policy Support Instrument (PSI) at the end of the current PRGF-supported program. As such, the government wishes to negotiate the new PSI at the time of sixth review under the current PRGF arrangement.

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

October 24, 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 a second wave of 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) that has been recently submitted to the management of both the International Monetary Fund (IMF) and World Bank. The Government's economic program is supported by the 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 PRGF-supported program (January 2006–September 2006) and describes the policies and targets for the remainder of 2006 and 2007.

**I. RECENT PERFORMANCE UNDER THE PRGF-SUPPORTED PROGRAM**

2. In 2006, economic performance remains favorable. Led by strength in the agriculture and construction sectors, real GDP growth has continued to be broad-based and is expected to accelerate slightly, from 7.7 percent in 2005 to 7.9 percent in 2006. Good rainfall, following the 2005 drought, resulted in a regular harvest season and has improved food security. Reflecting lower food prices, the cumulative headline inflation rate has slowed down since May to 4.8 percent in September, putting the year-end inflation target, 7 percent, within reach, although higher world oil prices may add pressures on price stability. The foreign exchange market has remained stable following the introduction of a temporary exchange rate band in the interbank foreign exchange market (MCI) in November 2005. The net international reserves (NIR) target for end-June 2006 was met and spread between the MCI rate and rates quoted by banks and bureaux has narrowed, and the real effective exchange rate has appreciated by about 5 percent since end-2005.

3. Fiscal performance for the first semester of 2006 was better than programmed. Revenue collection is above target led by buoyant corporate and VAT tax collections, and domestic-related expenditures are in line with the program. This resulted in a lower domestic primary deficit. However, the share of priority spending was somewhat below target reflecting a low rate of project execution so far.

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 promulgated in February 2006. The implementing regulations for the ATM law were approved by the Council of Ministers with a slight delay in July 2006 (structural benchmark) and the ATM strategic plan has been completed. The organic law of tax tribunals was also approved in April 2006, and operationalized with the selection of

professional judges. In addition, the following measures were implemented:

(i) identifying and collecting tax arrears; (ii) increasing the number of taxpayers to 360,000; and (iii) conducting a larger number of tax audits.

5. Public Financial Management (PFM) reforms have made good progress. The medium-term fiscal framework (CFMP) is closely aligned with the objectives of PARPA II, and was, for the first time, approved by the Council of Ministers in May 2006. The Government is implementing 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, and rolled out the system to the Ministries of Finance, Planning, Education, Agriculture, Health, and Public Works, at the central and provincial levels (structural performance criterion) since July 2006. To avoid having to go through a cumbersome process of converting the budget proposals into e-SISTAFE, a simplified new IT system (Phase I of the new budget formulation module) was implemented, and was ready in time to support the preparation of the 2007 budget. Good progress was made in integrating donor-financed projects into the 2007 budget ceilings including through the issuance of accounting guidelines, while challenges remain in bringing those projects on to the treasury single account (CUT). Pending the implementation of a new revenue collection network, revenue departments current's IT system (RCN) was updated to classify revenues according to SISTAFE's needs when they are transferred to the CUT and help with the treasury's financial programming capacity. Finally, a prioritized strategy was developed by end-September 2006 (structural benchmark) to progressively rollout e-SISTAFE to districts based on their administrative and infrastructure capacity.

6. Monetary policy has remained prudent. The performance criterion on base money was met for end-June 2006. This helped the introduction of the new family of meticaís (MTn) proceed smoothly on July 1, 2006. Interest rates increased following the removal of interest rate caps in government securities auctions completed in March, albeit declining in August following the Bank of Mozambique's (BM) decision to lower its *Facilidade Permanente de Cedência (FPC)* rate alongside the deceleration in inflation. Net credit to the government (NCG) was lower than programmed, which also contributed to keeping broad money growth below its end-June target.

7. Prudential ratios of the banking system have remained sound. The ratio of non-performing loans to total loans has remained below 5 percent while the requirement to provision 50 percent of their foreign currency-denominated loans to nonexporters since July 2005 has led to a deceleration in foreign currency loan growth. Moreover, credit growth to the economy has remained strong, and the commercial banking system appears to be well capitalized. Finally, in order to strengthen the balance sheet of the BM, securities in an amount of MTn 1.5 billion were issued to BM in June 2006 as envisaged in the program.

8. In the area of accounting, the BM adjusted its Chart of Accounts in 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. The revision of the Chart of Accounts of the commercial banking system, consistent with

IFRS, is being finalized, but a circular will be issued by end-November 2006 (originally planned by end-September 2006; structural benchmark).

9. Progress on structural reforms in 2006 accelerated, particularly in the areas of public sector, labor market, and trade-related reforms. The government is strengthening efforts in the area of public sector reform through the second phase of the strategic action plan (2006-2011). The plan was approved by the Council of Ministers in October 2006, with a special focus on decentralization. A public service authority (ANFP) was recently established, reporting directly to the President, to give the reform a stronger impetus. In addition, a preliminary draft of a strategy paper on decentralization has been prepared including fiscal issues. The new draft Labor law has been approved by the Council of Ministers and submitted to the Assembly. In the area of trade reforms, in January 2006, the maximum import tariff rate applicable to SADC trading partners was lowered from 25 to 20 percent. With respect to the latter, the government continued negotiations with Angola, Tanzania and Zambia in order to reach agreements similar to the ones concluded with Zimbabwe and Malawi in 2005. In addition, the Government has continued with streamlining licensing procedures through “one stop shops”, computerizing the company registry, and the e-Government portal, and pursuing bilateral free trade arrangements as recommended in the Diagnostic Trade Integration Study (DTIS).

10. However, less progress was made to increase access to finance through deeper reforms that would improve the lending environment, such as legal and judicial reform, the use of collateral, and availability of creditor information, as well as deepening of domestic debt markets. Despite the initiation of commercial sections in the Judicial Tribunals of the city of Maputo, Sofala and Nampula, further capacity building is needed with the help of donors, including the World Bank. The remaining weaknesses in the justice sector and backlog of cases are also causing an increasing impediment not only in dealing with criminal cases and corruption, but in relation to labor issues and the development of a vibrant private sector. In addition, challenges remain in the implementation of new national procedures such as procurement, accounting, reporting and audit which needs to be further strengthened with close collaboration with donors, in particular at the district level

11. Little progress has been made in collecting the necessary information to monitor adequately the mega-projects and the eleven public enterprises, as well as the 164 participating enterprises. While the unit to monitor the megaprojects has not been created as envisaged under the program, the government has decided to create a research department within the Ministry of Finance in 2006, with a key function to gather information on megaprojects, and public and participating enterprises.

## **II. THE POLICY AGENDA FOR 2006 AND 2007**

12. The policy framework, which aims at consolidating macroeconomic stability, is consistent with the medium-term goal of sustaining poverty reduction through strong broad-based economic growth. The Government is committed to continue to implement measures to strengthen revenue mobilization and 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 in the context of PARPA II.

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). The research department of the Ministry of Finance will collect and analyze information on megaprojects and public enterprises by end-March 2007. The pricing mechanism will continue to be implemented automatically and transparently for all petroleum products.

13. All end-2006 quantitative targets are within reach. The 2006 fiscal stance will reflect additional priority expenditures identified in the 2006 budget that were contingent on the MDRI while domestic revenues are expected to reach 14.4 percent of GDP as originally envisaged. It is also anticipated that the share of spending on priority sectors out of total primary expenditures will exceed the 65 percent target as donor-financed project execution picks up at the end of year. Overall, the domestic primary deficit will be 2.5 percent of GDP with a negative net domestic banking financing of 2.5 of GDP. This along with an unchanged base money target will help achieve the 7 percent inflation target while the comfortable level of international reserves will help cushion against exogenous shocks.

14. Prospects for 2007 remain favorable with a continuation of strong economic growth and control of inflation to single digit levels. Central to achieving these objectives will be a gradual fiscal strengthening backed by an average revenue increase of 0.5 percent of GDP per year and a prudent monetary policy. The 2007 budget is based on the CFMP. The structural reform agenda, as detailed in the PARPA II strategic matrix, includes a second wave of reforms to sustain broad-based growth and poverty reduction. In addition to fiscal reforms to increase revenue mobilization and strengthen expenditure management, the Government will deepen institutional reforms to (i) promote good governance, (ii) buttress the investment climate and ease growth constraints, and (iii) strengthen the transparency of natural resource management and megaprojects. To maintain competitiveness and a comfortable level of international reserves, the BM will bestow greater exchange rate flexibility in the foreign exchange market.

15. The 2007 budget envisages a scaling-up of aid and an associated increase in priority spending focused towards achieving the PARPA II targets including sufficient counterpart funds to ensure a smooth execution of donor-financed projects. There will be no recourse to domestic financing. Total domestic revenue is envisaged to rise by 0.5 percent of GDP compared to 2006 by broadening the tax base through a continued increase of the number of taxpayers, elimination of unwarranted tax exemptions, collection of new tax arrears amounting to about 0.2 percent of GDP, and quarterly updating of the specific fuel tax rate, and finalize discussions with the interested parties on the efficient use of container scanners. The expenditure side will reflect a 7.5 percent ratio of the wage bill to GDP as envisaged in the MTFF, including a hiring of about 10,000 teachers and 3,000 health workers. The share of spending on priority sectors (above 65 percent), particularly education, health, and infrastructure, has been agreed with the donors and will be closely monitored.

16. The government will continue to improve the efficiency of the tax system by sequentially implementing its tax policy reform benefiting from Fund technical assistance. Progress on tax reform will be closely monitored within the MF. In the first semester of 2007, tax policy measures will be defined to equalize the treatment of interest

income on different assets, streamline and simplify the tax system for small and medium-sized enterprises, and reduce VAT exemptions. An external audit will be undertaken with the assistance of donors to assess the amount of arrears on VAT refunds due to contractors of large infrastructure projects, particularly in the road sector. On the basis of this audit a payment schedule will be defined to clear the arrears. Going forward, the government will ensure that VAT charged on supplies of projects be included in the final price of a contract.

17. The next phase of the revenue administration reforms (2007–10), to be supported by a multi-donor common fund, will focus on establishing the ATM as a sustainable, semi autonomous institution, and improving operational performance to help achieve the medium term revenue targets. The Government is committed to supporting the phased integration of the core functions of both tax and customs administration by initiating the implementation of the strategic plan of the ATM in late 2006 and 2007 following the appointment of a President of the ATM in October 2006. Revenues administration measures envisaged in 2007 include: (i) reducing the levels of stop filing, especially with respect to large taxpayers; (ii) initiating procedures to recover tax arrears generated during 2005 and 2006; (iii) providing a better service to taxpayers by reducing the average time to resolve VAT refunds claims; (iv) establishing an audit plan for 2007 at the DGI aimed at broadening audit coverage for domestic taxes; (v) facilitating trade through the reduction of the average time to release imported goods at the border; and (vi) implementing the IT Plan (PDTI).

18. The medium term PFM Action Plan and Budget (APB) for 2006–09 agreed with the donors includes the following main elements: rollout of the budget execution module to all central and provincial entities, and its customization to district and municipalities needs; the introduction of Phase II of the budget formulation module; and the development of new modules and functionalities. Specific measures of the APB include:

- a. First, 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 by end-January 2007 (structural benchmark).
- b. Second, the Inhassoro version, the software that will allow for the closure of the 2006 budget and the production of the financial accounts of the state within e-SISTAFE, as well as the report generation facility will be operational by end-2006.
- c. Third, the development of a payroll and pensions functionality is a high priority for 2007. It is, however, dependent on the census of the civil service scheduled to be completed by end-April 2007 (structural benchmark). This census will provide a unique biometric identification number for each public employee and be used to develop an integrated payroll database that will be compatible with e-SISTAFE. Following this,



the e-SISTAFE payroll functionality will be ready by end-June 2007 and the pension functionality by end-September 2007.

- d. Fourth, a district version of e-SISTAFE, customized to their needs, will be rolled out to only 27 out of 128 districts in 2007, duly taking into account their administrative capacity and infrastructure conditions.
- e. Fifth, the Phase II of the budget formulation module will be tested and ready for use by end-June 2007, to fit in with the 2008 budget calendar.
- f. Sixth, to automate revenue collection and classify all government revenues before transferring the funds to the CUT, a fully articulated business case will be prepared by end-June 2007 to implement a revenue collection network (RCN) based on the already developed IT structure of e-SISTAFE.
- g. Seventh, to facilitate the inclusion of all donor-financed projects within the CUT, a limited number of separate foreign currency accounts will be opened within the CUT by end-March 2007 (structural benchmark), and be subject to the SISTAFE regime.
- h. Finally, the implementation of the asset management system and procurement interface to e-SISTAFE will be moved forward by the development of requirement specifications and tender by end-June 2007.

19. On monetary policy, the BM will continue to target base money with a view to achieving its inflation target. A long-term monetary policy strategy document was approved by the executive board of the BM in October 2006 that defines an intermediate target compatible with the base money operational target, a new format for the monetary policy committee, and specifies its communication policy. To achieve the inflation objective of 6 percent by end-2007, base money growth will be limited to 15 percent or slightly higher than nominal GDP growth to take into account the ongoing financial deepening. In addition, the monetary authority remains committed to a flexible exchange rate regime and to that effect will gradually widen the temporary exchange rate band in the foreign exchange market when conditions permit.

20. The BM will continue to improve liquidity management, and deepen financial markets as part of the Financial Sector Technical Assistance Program (FSTAP). In this context, the MF, in turn, will improve the preparation of cash-flow projections and communicate it to the BM in a timely manner with Fund technical assistance. Moreover, with World Bank technical assistance, the BM will finalize a master repurchase agreement by end-May 2007. The 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 with Fund technical assistance.

21. The BM introduced a new family of meticais on July 1, 2006 (1000 old family of metical is equal to one new family of meticais, MTn). The BM expects about 90 percent

of MTn in circulation by end-2006. The BM intends to open five provincial agencies, (three before end-December 2006) to help complete the introduction of the MTn and enhance the payment system.

22. The BM will also continue to strengthen and modernize its supervisory functions. In this regard, training to adopt a risk-based supervision approach will start in 2007, at which time the new inspection manuals will also be used. A proposal on the new organizational structure of the banking supervision department consistent with the Integral Strengthening Plan for Banking Supervision will be approved by end-December 2006. These organizational changes will also strengthen on-site and off-site monitoring.

23. The Government remains committed to strengthening the balance sheet of the BM. To this end, the Government will issue the last tranche of 1.5 billion MTn recapitalization bond to the BM by end-June 2007.

24. 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 in 2007. The BM will issue its financial statements in line with IFRS in 2007. The BM will also ensure compliance with the new standards in the banking sector. The 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 will be approved by end-2006, and become effective beginning 2007.

25. The Government is committed to supporting a sound expansion of the non-bank financial sector. The BM will continue to 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 has been submitted to the Assembly. As part of the restructuring of the National Social Security Fund (INSS), an actuarial study will be completed before the end of 2007. In the meantime, guarantees of minimum benefits will be limited until the full study is carried out. 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.

26. The BM is committed to implement in 2007 all the remaining actions needed to address weaknesses identified in the context of the Fund's safeguards assessment mission conducted in June 2004. In particular, progress is 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.

27. Regarding the foreign exchange system, a new foreign exchange law taking into account comments from all stakeholders and the Fund, will be submitted with a slight delay to the Assembly by end-March 2007. 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.

28. The Government expects to further liberalize the trade regime during 2007 by extending the reduction of the maximum import tariff rate from 25 to 20 percent for all trading partners, and has submitted a legislative authorization bill to the Assembly to this effect. During 2007, the government will continue ongoing Economic Partnership Agreement (EPA) negotiations, with technical advice under the Integrated Framework.

29. The Government looks forward to completing the buyback operation for its commercial debt in early 2007 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 efforts to negotiate with good faith 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 creditors as soon as possible including commercial creditors. In this regard the Government of Mozambique looks forward to the continuing support of the Bretton-Woods institutions.

30. The Government of Mozambique is conscious that despite its efforts to improve its investment climate during the year 2006, its ranking in the ease of doing business, as assessed in the Doing Business report 2007, has worsened to 140<sup>th</sup> place. The recent authorization to publish the bylaws of firms electronically may help to improve the ranking. However, it is not sufficient to make Mozambique's business environment the most competitive in SADC by 2015. To address this challenge and significantly improve the investment climate in Mozambique, the Government will develop a strategic action plan by end-March 2007 with the assistance of the World Bank to implement key reforms covering the period 2007–15. In 2007, the four key actions envisaged will include:

- a. Further simplifying the process to start up a business by expanding the computerization of the registration process to all the provinces.
- b. Adopting a system of inspections that would be business friendly and better coordinated across the several ministries that undertake inspections.
- c. Making it less costly and time-consuming to close a business by simplifying process and increasing the recovery rate for viable businesses to overcome a short-term cash flow crisis, and insolvent businesses to be rapidly liquidated.

31. The Government will continue to restructure and encourage private participation in public enterprises, particularly infrastructure services. A decision was made by the Council of Ministers in May 2006 to develop a new restructuring plan for PETROMOC that would improve efficiency. The new restructuring plan will be completed by end-June 2007 for its adoption by the Council of Ministers by end-September 2007. The Government with the help of the World Bank will continue to put in place measures to assist the state-owned electricity company (Electricidade de Moçambique, EDM) to

improve performance, including through a performance contract and the operationalization of the regulator (CNELEC) by end-June 2007.

32. The Government recognizes the importance of improving the fiscal regime of mineral and petroleum resource projects. Accordingly, the Council of Ministers will, before the end of November 2006, approve a new draft Mining Fiscal Regime law (structural performance criterion, end-December 2006). A law would be submitted to Parliament for its first session of 2007. In the interim, the Government will ensure that any new mineral resource project agreements will adhere to the principles of the new draft Mining Fiscal Regime law. While the new draft law will be the essential foundation for an improved mining fiscal regime, the Government will also strengthen its negotiating tools, including by developing a model contract and the capacity to undertake timely feasibility studies and financial modeling. With regards to the petroleum sector, the government will request for technical assistance from the international community to make the model contract more specific, and narrow the range of items for bidding or negotiation. After December 31, 2006 the Government will avoid signing any new *Exploitation and Production Concession Contracts* (EPCs) in the petroleum sector until a new comprehensive petroleum fiscal regime is in place that would be embodied in the general tax law so as to avoid case by case negotiation of petroleum tax terms.

33. 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. The Government is already participating in a number of seminars on the EITI principles ending with a seminar in Maputo in January 2007. It is expected that the Government will consider to adhere to the EITI principles after the January seminar. Thereafter 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 the EITI principles.

34. With regard to the governments' anti-corruption strategy, operational action plans will be developed in five sectors by end-December 2006. The actions and outcomes undertaken by those sectors will be disseminated and closely monitored by dedicated committees within the reform umbrella, and a number of pending cases in the central bureau for anti-corruption will be executed in 2007.

35. In the context of the implementation of the Anti-Money Laundering Law, the Government is also committed to creating a financial investigation unit as soon as the law is adopted by the Assembly, hopefully during its March 2007 session.

36. Building on the lessons highlighted in the review of Phase I of the public sector reform program (2001–06), the Phase II document (2006–10) consists of three pillars: (i) human resource management including payroll systems; (ii) performance evaluation and wage policy; and (iii) decentralization and improving public service delivery. As part of its initial tasks the ANFP, is now carrying out a census of all civil servants to clean up the database and arrive at a unique number of total civil servants that may identify possible inexistent workers. By end-June 2007, the government will also identify clear options and a timetable for the wage reform, which is expected to result in the approval of a new wage policy in 2008. In addition, a decentralization strategy will be approved by the Council of Ministers by end-June 2007 that proposes, among other things, a clear

legal, regulatory, and institutional framework for revenue raising and spending responsibilities of subnational units (provinces, districts, and municipalities) and monitoring of subnational fiscal operations.

37. The *Decreto Lei do Ordenamento do Território* and the urban land use regulations were approved by the Council of Ministers in October 2006. This decree will enact a policy for land use which facilitates the reduction of costs and time involved in transactions, and which would then be submitted to the Assembly for approval. The government remains committed to conducting an economic analysis of urban land markets (formal and informal) as well as an associated poverty and social impact analysis (PSIA) of urban land tenure regulations, with the assistance of the World Bank. The government is preparing a draft strategy for slum improvement.

38. The Government will reinvigorate the reform of the judicial reform with the help of the international community. The Penal Procedure Code will be approved by Council of minister by end-December 2006 and submitted to the next session of the Assembly. The organic law of judicial tribunals is expected to be approved by the Assembly in the next session of the Assembly in early 2007. A new insolvency law is also under preparation and will be submitted to the Assembly in early 2007.

39.

### **III. PROGRAM MONITORING**

40. The semiannual quantitative performance criteria for end-December 2006 and indicative targets for end-March 2007, will be used to evaluate the implementation of the program for the remainder of 2006 and 2007 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 and 2007.

41. The Government understands that its ability to request the disbursement of the seventh loan under the PRGF arrangement will be contingent upon the observance of the performance criteria for end-December 2006 set out in Table 1 and 3; and the completion of the sixth review under the program, which is expected to take place before end-June 2007. In reviewing developments under the program during the sixth review, particular attention will be paid to the implementation of measures aimed at broadening the tax base and rolling out the e-SISTAFE, the 2007 budget, monetary and financial sector reform, reducing the cost of doing business, and improving the fiscal regime and transparency of mineral resource exploitation and megaprojects as well as their net contribution.

Table 1. Mozambique: Quantitative Performance Criteria and Indicative Targets, 2006-2007 1/  
(In millions of MTn, unless otherwise specified)

	2006						2007			
	End-June Perf. Criteria	End-June Perf. Criteria	End-June Perf. Criteria	End-Sep. Indicative Target	End-Sep. Indicative Target	End-Dec. Perf. Criteria	End-March Indicative Target	End-June Indicative Target	End-Sep. Indicative Target	End-Dec. Indicative Target
	Prog.	Adj.	Prel. Act.	Prog.	Prel. Act.	Prog.	Prog.	Prog.	Prog.	Prog.
Net credit to the government (cumulative ceiling)	-3,800	-3,800	-7,413	-4,300	-5,760	-4,518	-938	-1,948	-1,713	-1,296
Stock of reserve money (ceiling)	12,033	12,283	12,201	13,209	12,999	14,038	13,596	14,031	14,990	16,020
Stock of net international reserves of the BM (floor, in millions of U.S. dollars)	1,097	1,084	1,156	1,073	1,107	1,063	1,101	1,142	1,150	1,149
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	0	0	0	0	0	0	0
Stock of short-term external public debt outstanding (ceiling)	0	0	0	0	0	0	0	0	0	0
External payments arrears (ceiling)	0	0	0	0	0	0	0	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	100	83	83	83	76	65	55	35
Government revenue (floor)	11,232	...	11,865	18,314	...	26,052	6,281	14,554	22,671	31,342

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

Note: While the new family of meticaïs (MTn) was introduced in July 2006, values in this tables have been converted to MTn to reflect this change for ease of comparison.

Table 2. 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
<b>Structural performance criterion</b>		
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	Met
<b>Structural benchmarks</b>		
The implementing regulations for the ATM law will be approved by the Council of Ministers.	End-June 2006	Not met. Met in July 2006
Establish tax tribunals in Maputo, Beira, and Nampula for domestic taxes.	End-June 2006	Met
The Government will complete a prioritized plan to gradually rollout e-SISTAFE to all districts.	End-September 2006	Met
Adjustments to the BM's Chart of Account will be approved.	End-September 2006	Met
The Chart of Accounts of commercial banks will be made consistent with IFRS.	End-September 2006	Not met. Delayed to November 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	

Table 3. Mozambique: Structural Performance Criterion and Benchmarks Under the 2006 and 2007 PRGF-Supported Program (October 2006–June 2007)

Actions	Expected Date of Implementation	Comments
<b>Structural performance criterion</b>		
Approval of the new draft Mining Fiscal Regime law by the Council of Ministers.	End-December 2006	
<b>Structural benchmarks</b>		
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-January 2007	
A limited number of separate foreign currency accounts will be opened within the CUT.	End-March 2007	
Completion of the civil service census.	End-April 2007	



## ATTACHMENT II

### TECHNICAL MEMORANDUM OF UNDERSTANDING ON SELECTED CONCEPTS, DEFINITIONS, AND DATA REPORTING UNDER MOZAMBIQUE'S PRGF-SUPPORTED PROGRAM

October 24, 2006

1. This technical memorandum of understanding (TMU) 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 2006 for the 2007 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 Tributária 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 2007 will be the total stock of base money outstanding at end-June 2007, end-September 2007 and end-December 2007, 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). In addition, the quantitative targets (floors) for the central bank's net international reserves will be adjusted upward (downward) by the amount of donor-financed projects deposited in the MTn single treasury account (CUT) if they are higher (lower) than projected for each quarter (Table 1).

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-December 2006, end-March, end-June 2007, end-September 2007 and end-December 2007 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 MTn 500 million.

19. The base money ceiling will be adjusted equivalently upward up to a maximum of MTn 250 million at end-December 2006, end-March, end-June 2007, end-September 2007, and end-December 2007 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 and 2007  
(In millions of MTn; unless otherwise indicated)

	2006						2007				
	Q2 Prog.	Q2 Prel Est.	Q3 Prog.	Q3 Prel Est.	Q4 Prog.	Year Prog.	Q1 Prog.	Q2 Prog.	Q3 Prog.	Q4 Prog.	Year Prog.
Foreign program assistance	1361.6	2050.3	1932.1	813.7	635.9	7908.3	5018.0	3885.5	2415.7	2415.2	13734.5
Program grants	1361.6	2050.3	1151.6	813.7	635.9	5624.9	2572.0	2572.0	1102.3	1102.3	7348.6
Program loans	0.0	0.0	780.5	0.0	0.0	2283.4	2446.0	1313.5	1313.5	1313.0	6385.8
External debt service	393.2	154.0	325.2	..	435.7	1461.6	-154.7	-191.4	-202.7	-181.2	-730.0
Disbursement of donor-financed projects (in millions of US dollars)	...	...	...	...	...	...	0.0	20.0	20.0	20.0	60.0

Source: Mozambican authorities; and Fund staff estimates.

Table 2. Projected Fuel Import Bill, 2006-07  
(In millions of U.S. dollars, unless otherwise indicated)

	2006	2007			
	Prog.	End-Mar. Prog.	End-Jun. Prog.	End-Sept. Prog.	End-Dec. Prog.
Fuel Import Bill	312.1	38.5	101.4	63.4	128.9
Forecast Oil price (US\$ per barrel)	61.3	61.8	63.0	64.0	64.3
Volume of fuel imports (in metric tons)	520,969	76,466	166,893	106,061	193,426

Sources: Mozambican authorities and Fund staff projections

Quarter	End- December 2006	End- March 2007	End- June 2007	End- September 2007	End- December 2007
Currency issued by BM	7,690	7,305	7,596	8,154	8,667

Source: Mozambican authorities; and Fund staff projections.

### SISTAFE Implementation Plan

<b>Action</b>	<b>Expected date</b>
<p>Implementation of Homoine in 6 sectors:</p> <ol style="list-style-type: none"> <li>1. (MEC) Ministry of education and culture;</li> <li>2. (MF) Ministry of Finance;</li> <li>3. (MPD) Ministry of Planning and development;</li> <li>4. (MISAU) Ministry of Health;</li> <li>5. (MINAG) Ministry of Agriculture and,</li> <li>6. (MOPH) Ministry of Public Works.</li> </ol> <p>All at Central and Provincial level, thereby gradually abolishing disbursement of funds by introducing direct budget execution and not including the external component.</p>	31 <sup>st</sup> of July 2006
Priorities for roll-out to Districts to be defined and elaborated	31 <sup>st</sup> of September 2006
<p>Rollout to the following Ministries and Organs:</p> <ol style="list-style-type: none"> <li>1. (MAE) Ministry of Home affairs;</li> <li>2. (MI) Ministry of Interior</li> <li>3. (MD) Ministry of Defense</li> <li>4. (MTS) Ministry of Technology and Science</li> <li>5. Presidency of the Republic</li> <li>6. Assembly of the Republic</li> <li>7. Office of the Prime Minister</li> <li>8. Conselho Superior da Magistratura</li> <li>9. Casa Militar</li> <li>10. Tribunal Administrativo</li> <li>11. Conselho Constitucional</li> <li>12. Tribunal Supremo</li> <li>13. Procuradoria Geral da República</li> <li>14. (MIC) Ministry of Industry and Commerce;</li> <li>15. (ME) Ministry of Energy</li> <li>16. (MRN) Ministry of Natural Resources</li> <li>17. (MICOA) Ministry of Environmental Coordination</li> <li>18. (MITUR) Ministry of Tourism</li> <li>19. (MTC) Ministry of Transport and Communication</li> <li>20. (MP) Ministry of Fishery</li> <li>21. (MM) Ministry of Woman and Social Action</li> <li>22. (MJ) Ministry of Justice</li> </ol>	1 <sup>st</sup> of January 2007