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ECONOMIC

ANNEX

MOZAMBIQUE

COUNTRY STRATEGIC PLAN

FY 1996 - FY 2001

Historical Overview

I. The Colonial Legacy

After initially establishing settlements in Mozambique, primarily along the coast, the Portuguese attempted to control the large indigenous states that dominated the interior in the latter half of the sixteenth century. The two major indigenous powers were brought under Portuguese domination by the end of the 1630s which allowed Portugal to distribute land to white settlers in the form of prazos (land grants), which were intended to serve as the basis of a permanent European presence. The expansionist policy of the Portuguese was relatively successful until the latter half of the seventeenth century when rekindled resistance to the European invaders led to the expulsion of the Portuguese from all but a few coastal areas. This situation continued for roughly the next two centuries. In spite of repeated armed expeditions, the Portuguese controlled no more than a small radius of a few kilometers around each of their coastal settlements.

Some of the economic characteristics of modern Mozambique were clearly present throughout most of the pre-colonial and colonial periods. First was the importance of primary commodity exports to the outside world. Gold was dominant during the sixteenth and seventeenth centuries and ivory became more important thereafter. Second was the role of Mozambique as a supplier of labor. The slave trade grew to become the most important economic activity in terms of the international economy by the beginning of the nineteenth century and remained important even after the official abolition of the slave trade in 1836. Exports of laborers continued into the twentieth century in the form of mine workers for South Africa, for which the colonial government, not the workers themselves, received payment in gold.

After the Portuguese achieved the subjugation of indigenous states in the twentieth century, several policies were designed to force Mozambicans to work as contract laborers off-farm. Taxes, which could only be paid in cash, were an effective means of forcing the population into wage labor. In addition, production requirements for cotton and rice forced those remaining on the farm into the cash economy. Closely controlled at all stages by the colonial authorities, these crops were intended to provide food and raw materials for Portugal, which monopolized production of manufactured goods.

Two important aspects of the Portuguese regime that have had profound effects in the period after independence were: 1) the extreme reluctance of the authorities to provide or allow any education or training of Mozambicans beyond a very basic level; and 2) a policy of restricting all jobs requiring even minimal skills to Europeans.

The reliance of Mozambique on labor remittances and service payments in the balance of payments was a structural characteristic of the colonial period that foreshadowed the need for structural adjustment policies in later years. Merchandise exports never amounted to more than half of merchandise imports, with receipts from laborers (mainly in South Africa), transportation and tourism playing more important roles.

Before independence, economic activity centered around five activities: 1) subsistence agriculture; 2) the processing of agricultural commodities for export; 3) migrant labor; 4) transport of goods between Mozambican ports and the landlocked areas of Southern Africa; and 5) tourism services. Traditional subsistence agriculture was focused on growing food crops, primarily maize. Production for export centered around four commodities: 1) cashew nuts; 2) prawns; 3) cotton; and 4) tea. Migrant labor mainly went to South Africa to work in the mines, although some migrant Mozambican labor also worked in the copper mines in the Zambia. Transit trade from the Transvaal province of South Africa, Zimbabwe and Malawi was an important source of foreign exchange. In addition, tourism receipts, primarily from the above countries and Portugal, also constituted an important source of foreign exchange.

Prior to independence, private commercial farming in Mozambique was largely defined by concession agriculture, with the exception of cashew and, to a lesser extent, cotton which were grown by smallholders. Subsistence farming on traditional lands dominated as it does today. In theory, an African farmer could obtain clear title up to two hectares. However, financial capability had to be demonstrated, and demarcation and survey of the land were also required. The process was expensive and complicated. Large concessions displaced native Mozambicans from large areas of the country's best agriculture land and effectively denied them future access. During the colonial period, less than 15 percent of the land was under cultivation. Over 50 percent of the cultivated land was in the hands of a few large European- controlled farms which produced cotton, sugar, tea, sisal and processed cashews. Another 25 percent was occupied by small commercial farms (greater than twenty hectares) and managed by Portuguese settlers and a few African farmers. The large majority of the population farmed traditional communal lands or worked on large plantations.

Industrial production in Mozambique was initially based upon agroprocessing of locally produced goods such as sugar and sisal. Small-scale manufacturing began to emerge in the 1930s in products such as cement, bricks, soap, beer and cigarettes with the market for these industries being largely provided by the small settler community. This process of industrial development continued for the next thirty years with diversification into other consumer and intermediate manufacturing, including food processing, garments, footware, furniture, glass and metal products. After 1965, the Portuguese opened the economy to foreign investment, particularly from South Africa. This forced new enterprises to be internationally competitive and avoided the development of inefficient industries. This open door policy, up to 1974, included a series of incentives such as tax holidays and profit repatriation entitlements. The rate of growth of industrial output, between 1957 and 1970 according to available information, averaged between 6 and 7 percent per annum. The metals and engineering industry subsectors recorded annual growth rates above 30 percent. In 1973 total manufacturing value added per capita was estimated to be the sixth largest in Sub-Saharan Africa and, by 1974, Mozambique was the tenth most industrialized country in Sub-Saharan Africa. However, the industries that did develop tended to be highly dependent on imports, were frequently equipped with second-hand machinery and were reliant upon foreign management and technicians.

II. Post-Independence Period: 1975-1981

After a long period of civil war in the fight for independence led by the Mozambican Liberation Front (FRELIMO) against the Portuguese rulers, Mozambique became independent in 1975. Mozambique experienced a substantial exodus of Portuguese settlers at the time of independence which severely depleted the available pool of skilled labor. Estimates of the exodus are put at 200,000 people (90 percent of the skilled and semiskilled labor force). Up to the time of independence, little emphasis had been put on development of social or physical infrastructure. The effects of the withdrawal pervaded the economy. The main effects were felt in plantation agriculture, rural marketing and distribution, administration of the ports and railways and the civil service. The impact of the exodus was further felt by sabotage of productive resources by departing Portuguese. Further revenue losses in the immediate post-Independence period were due to damage and losses from attacks on the railways by RENAMO which caused diversion of the transit trade from the Transvaal in South Africa, which had been an important source of income for the port of Maputo to other South African ports rather than through Mozambique. Further changes in South Africa which reduced the job opportunities for Mozambican mine workers in the South African mines led to an important decline in remittances. Tourism receipts fell substantially as the number of tourists visiting Mozambique declined dramatically due to the civil strife between FRELIMO and RENAMO. Mozambique entered its immediate post-independence period facing severe economic strains.

At the time of independence in 1975, Mozambique was a relatively prosperous country with an economy built on a strong agricultural and industrial base and provision of transport and labor services to neighboring countries, particularly South Africa. However, several factors were in place which led to a substantial deterioration in economic performance, including: 1) a colonial legacy of very low investment in human resources; 2) inappropriate Marxist economic policies; 3) weak civil service capacity, exacerbated by the emphasis on centralized planning; and 4) the civil war which devastated much of Mozambique's countryside and infrastructure.

The Government of the Republic of Mozambique (GRM) implemented Marxist policies that centralized economic planning. Physical controls over production, allocation and prices were instituted and resources were concentrated in large capital-intensive agricultural and industrial investments in the public sector. Mozambique inherited an economy largely geared to servicing the raw materials requirements of Portugal and the manpower needs of neighboring countries (which meant that it was neither internally physically nor economically). Few Mozambicans were employed in the modern sector, especially in managerial positions.

Immediately following independence, high priority was assigned to social services, particularly health and education. The GRM committed itself to the establishment of an expenditure program with emphasis on poverty alleviation, including a massive program of expansion of social services with an emphasis on primary education, adult literacy and primary health care. However, the combined effects of macroeconomic mismanagement (thereby reducing real resources available to the social sectors), population growth (augmenting service demand) and widespread destruction and disruption caused by the war led to a substantial decline in service delivery capability and jeopardized its sustainability.

After a brief recovery in 1977 and 1981, the economic situation deteriorated under the combined effects of the civil war and a misguided development strategy based on central planning and heavy government intervention in the productive sectors. State farms and production cooperatives were established on the large estates abandoned by their pre-independence owners and on communal lands. Communal villages were established and in some cases people were forcibly relocated. The Government accumulated a substantial external debt to finance inefficient and nonsustainable mechanization and irrigation schemes on state farms while the smallholder sector, which accounted for almost all of the country's food production was deprived of basic agricultural services, penalized by the GRM's macroeconomic policies and the inefficiencies of parastatals. Also, smallholders were gradually isolated from markets by the disruption of the private marketing network and the destruction of road infrastructure brought about by the war.

Under the new Marxist constitution, all land henceforth belonged to the whole people through the State. Large and medium-scale private enterprise in the agriculture sector was discouraged. With the flight of large numbers of Portuguese settlers and plantation operators, the government intervened in the operations of farms and businesses on a de facto basis to provide salaries for the farm and industrial labor forces and to maintain commercial production in the agriculture sector. State farms and production cooperatives were established on the large estates abandoned by their pre-independence owners (Portuguese settlers) and on communal lands. Two programs were introduced by the FRELIMO government: 1) reorganization and operation of medium and large intervened plantations and other commercial production schemes at large state farms and enterprises; and 2) development of communal villages involving cooperative production. Little was invested in them and the resentments which the mass relocations caused among the population was a main factor in direct and indirect support to RENAMO in some rural areas. Only a relative few still survive as functioning service cooperatives.

In contrast, the GRM invested heavily in the State farms. These farms were created through consolidation of plantations, medium-sized farms and small holdings. The properties themselves were frequently never officially nationalized, just simply taken over. The legal position was that "no formal confiscation was necessary or undertaken: the ownership disappeared with the owners, and, in terms of the provision of a general statute dealing with abandoned properties, the farms devolved to the state after a period of three months' absenteeism by the owners."[1] In addition, numerous holdings, including communal lands which had not been abandoned, were incorporated into State farms as well. Areas under cultivation were expanded and mechanization increased. The Government accumulated a substantial external debt to finance inefficient and nonsustainable mechanization and irrigation schemes on State farms while the smallholder sector

[1]Albie Sachs, "Mozambique Land Law", Committee of African Studies, Harvard University Press, 1989.

(which accounted for almost all of the country's food production) was deprived of basic agricultural services, penalized by the Government's macroeconomic policies and the inefficiencies of parastatals. Smallholders were also gradually isolated from markets by the disruption of the private marketing network and the destruction of road infrastructure as a result of the war. Like the cooperative sector, the State farm sector performed poorly.

Mozambique's industrial sector was relatively diverse in 1975 in comparison to other African countries in terms of output per capita, with most production taking place in the private sector. After independence, however, there was a severe deterioration in industrial activity. Two events occurred that dramatically changed the ownership structure and adversely affected the performance of the sector. First, there was the large-scale exodus of Portuguese and other foreign managers which had an immediate and serious impact on production. With the exodus the GRM took control of most industrial enterprises[2] in order to maintain production. Unfortunately, many of these enterprises were in a state of neglect and some had heavy debt arrears. Second, the shift to a centralized economy, was associated with the creation of a relatively large public sector. In addition, the decline in production in the immediate post-independence was exacerbated by sabotage of infrastructure as a result of the FRELIMO-RENAMO conflict. Combined with the world recession in the early 1980s and the increasing centralization of production, distribution and pricing (which prevented enterprises from adapting to adverse conditions), industrial production declined sharply.

III. Economic Crisis: 1981-1986

In the early 1980s the Mozambican economy experienced a marked and sustained decline in output, increasing economic distortions and financial imbalances, largely as a result of widespread insecurity in rural areas, periodic natural disasters and the application of inappropriate economic policies. In the decade to 1986, overall production fell about 30 percent, exports declined by 75 percent, and imports fell by 30 percent. External imbalances, aggravated by an increasingly overvalued exchange rate, led to substantial arrears in external debt service. Domestically, large fiscal deficits and unconstrained bank financing of enterprise losses led to a tripling of the money stock (within the context of shrinking output). Centralized control of prices and distribution further hindered the efficient allocation of resources, leading to shortages, inflation and a widespread movement to barter and parallel market activities for goods and foreign exchange.

Production dramatically collapsed between 1981-1986. Real GDP declined at an average annual rate of 3.5% per year with a similar decline in real per capita consumption. The steepest decline occurred in the industrial and transport sectors. Although the subsistence sector proved rather resilient, the decline in the agricultural sector was also severe, with a fall in agricultural GDP

[2]These 'intervened enterprises' were those abandoned by their previous owners and became controlled by the Government in order to maintain production. Intervention was mandated by a 1977 law of intervention. Formal nationalization was limited to petroleum refining and shipping.

estimated at about 5% per annum. By 1985, cotton and sugar production had collapsed to 9 and 16 percent, respectively, of their 1980 levels. The production of tea and cashew nuts, which together contributed a third of the country's total exports, fell to around 30% of their 1980 level. Between 1981 and 1986, the marketed production of maize and rice declined by about 50%. Although it is difficult to assess the production of subsistence agriculture, it is estimated that climatic problems and the massive displacements of populations led to a substantial decline in food production and that per capita food production in the subsistence sector may have fallen by as much as 30% between 1981 and 1986. As a result, the country became heavily dependent on foreign aid to guarantee a minimum level of food security to its urban population as well as in some rural areas. Although the endemic lack of basic security since independence and multiple natural disasters contributed to this poor economic performance, a clearly inappropriate policy regime also made a major contribution to this performance. For example, over the 1980-1986 period the GRM's total fiscal deficit, including grants, averaged 13.7% of GDP, while the total deficit, excluding grants, averaged 16.3% of GDP. An average 52% of these deficits were financed through expansion of the money supply (domestic bank financing). Based on a conservative estimate of the "appropriate" exchange rate, the average degree of exchange rate overvaluation for this period was 81%, i.e., a devaluation of 81% would have been required to reach the appropriate rate.[3] Real interest rates were negative, averaging a negative ten percent (-10%) for the 1980-1986 period. With the exception of monetary growth, policy performance worsened significantly during the 1984-86 period. The fiscal deficit (including grants) increased to 14.9% of GDP and almost 76% of this increased deficit was financed through the domestic banking system. Combined with the reduced growth in the money supply, these fiscal developments severely constricted credit to other sectors of the economy. The metical's overvaluation worsened, requiring an average 85% devaluation to reach an "appropriate" rate. Due to the increase in the rate of inflation, real lending rates fell to a negative 18.7% (-18.7%).

By 1983, with a civil war raging, the government gradually began to change its priorities, calling for increased attention to the smallholder and private commercial producers. A price liberalization policy was begun, initially for fruits and vegetables, foreign exchange retention was allowed and some State farms shut down. The GRM began to realize that it had neither the resources nor the management capabilities to make the State enterprises perform successfully. As the debts of the State farm sector to the banking system increased, their decline continued and more were closed or converted into joint venture operations with private management. By 1986, it was clear that economic policy reforms had to be implemented if there was to be a turnaround from the deteriorating conditions which characterized this period.

IV. Economic Adjustment: 1987-1994

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[3] As an indication of the conservative nature of the estimated appropriate exchange rate, the parallel market rate, expressed in meticais per U.S. dollar (MT/US$), was approximately 40 times the official rate in 1984, while the "appropriate" rate used in this calculation was only 4.5 times the official rate. The appropriate rate is based on a purchasing power parity projection using the exchange rate initially established when a market-based system was introduced in Mozambique.

By 1987, 60%-70% of the population was absolutely poor and Mozambique's social indicators were among the worst in the world. Much of the rural infrastructure had been neglected or devastated by more than ten years of civil war. A third of all health units and half of the primary schools had been destroyed. Much of the service networks were inoperative or barely functioned. Most enterprises had been nationalized or taken over by the State as "intervened" companies. The industrial sector was paralysed (output was only one-third of the 1973 level). The agricultural sector had reverted to subsistence levels. The consequence was a sharp fall in Mozambique's import capacity as exports fell by over two-thirds. Aid dependency had become extreme: because of the sharp decline in production and exports, 90% of marketed grain in the country had to be provided through emergency assistance. External debt was unmanageable with Mozambique's debt stock equal to 3.5 times GDP and 45 times its exports by 1986.

In 1987, the economy was a morass of interlocking problems. Even understanding the situation was difficult, let alone disentangling the issues and implementing remedial action. Enterprise profits and losses meant nothing because domestic prices were all out of line with world prices and there was no incentive to improve profitability. Profits were handed over to the Ministry of Finance (MOF), while operating losses were covered by subsidies and investment was financed by grants. The Bank of Mozambique, the central bank, was a typical mono-bank in a centrally-planned economy, ostensibly performing both central banking and commercial banking functions, but in reality acting as the accounting arm of the MOF. The exchange rate was grossly overvalued. Moreover, the information base was abysmal. Enterprise, banking and government accounts either did not exist or were in disarray. While Mozambique's economic problems were among the most difficult in the world to resolve, the country's human and institutional capacity to design and implement remedial action was among the weakest in the world, with very few graduates in the country and no possibility of adding to national capacity except by training a new generation of Mozambicans.

In order to stop the country's economic deterioration, the GRM adopted a comprehensive Economic Rehabilitation Program (ERP) in 1987, which represented a dramatic change in the country's economic development strategy. Under the ERP, and the subsequent Economic and Social Rehabilitation Program (ESRP) of 1989-1990, major reforms were introduced to move toward a market-based economy. Macroeconomic imbalances were reduced through a realignment of the real exchange rate, a reduction of the fiscal deficit and movement toward elimination of deficit financing by the banking system; the comprehensive administrative controls over prices and marketing that characterized the early 1980s began to be dismantled; major steps were taken to improve the terms of trade in favor of agriculture; and measures were taken to start removing the structural bottlenecks inhibiting a supply response, e.g., rehabilitation of the transportation network, availability of inputs and consumer goods.

In the initial period of adjustment (1987-1989), priority was given to making a start on reducing financial distortions (prices and the exchange rate), decreasing administrative controls over economic activity, rehabilitating state enterprises and mobilizing domestic resources. These actions required progress towards improved transparency (sorting out the accounts and information so that it would be possible to know what was going on, and rationalizing prices to provide better information on performance and desirable investments and to provide incentives to improve efficiency).

Over the next five years (1990-1994), the GRM established a more market-oriented foreign exchange system, initiated financial sector reform, freed domestic trade and controlled prices, continued enterprise reform and strengthened public expenditure (incorporated more off-budget items). The GRM's implementation of the program was complicated by a number of deep structural problems and severe external shocks. Aid from and trade with the former Soviet Union collapsed in 1991 and Mozambique lost key markets, particularly textiles, in Eastern Europe. The civil war worsened which caused an increase in the percentage of displaced households from 30% in 1988 to almost 50% in 1992. To further exacerbate the situation, the agricultural sector was devastated by the most severe drought of this century in 1991 and 1992.

The economic collapse of the 1981-1986 period was arrested under the ERP and ESRP. Real GDP growth averaged 9.8% during 1987-1991. However, real GDP growth contracted by 0.8% primarily because of the drought and a slowdown in industrial activity. All GDP expenditure components fell in 1992 except for public consumption which increased by 8.9 percent, largely as a result of the emergency expenditures related to the drought. In 1993, real GDP grew by 19% in response to the end of the war and the drought and increased the demand for goods and services created by the establishment of the U.N.'s third largest peacekeeping operation in the world. Real GDP growth in 1994 was a respectable 5.4% (7.7%, excluding trade). Agricultural experienced its fastest growth since 1988 during 1993-1994, while increased agricultural marketing and improved security led to more commercial activities in rural areas. As a result of the reconstruction of the road and rail links throughout the country as well as private home construction, the construction sector expanded at a real rate of 7.5 percent in 1994. However, the industrial sector continued to decline for the fifth straight year.

Trade reform has been undertaken including a rationalization and reduction in some tariffs, with specific taxes replaced by *ad valorem* rates, a significant reduction in the large number of rates, a lowering of rates and the dismantling of quantitative restrictions. Mozambique is continuing to simplify its foreign trade regime. It has gradually reduced the number and spread of import tariffs since 1991 and has authorized import licenses automatically (except for products included on a negative list). All export retention schemes have been abolished. A package of measures was implemented in late 1993 to promote exports, including a further simplification of licensing procedures, elimination of remaining export tariffs, and a reduction in import tariffs. The external account deficit after grants reached $316 million in 1993 (85% of exports of goods and services). In 1994, merchandise exports by 13.4 percent to $149.5 million, below expectations largely due to the decline in processed cashew exports. Imports increased in 1994 by 6.7 percent to $1.02 billion (75 percent of which was financed by donor import support funds), contributing to the decline in the current account deficit, after grants, from 21.9 percent of GDP to 20.8 percent of GDP in 1994.

Despite significant debt relief since 1987, Mozambique still has an external debt of over $5 billion, mostly owed to bilateral creditors. Mozambique concluded all bilateral agreements with creditors under the March 1993 Paris Club agreement (its fourth) except with Italy and Japan. Mozambique made substantial efforts to obtain agreements with non-Paris Club creditors on terms comparable to those granted by Paris Club creditors. Rescheduling agreements were reached with both Paris Club and non-Paris Club bilateral creditors in 1994. Debt rescheduling on concessional terms helped lower Mozambique's debt service ratio to 21% of exports of goods and services in 1993 but this still represents a heavy burden on the country's budgetary and external resources.

The official exchange rate was devalued by about 76% in real terms between 1986 and 1990 but foreign exchange and credit allocation remained administratively managed. The foreign exchange system moved toward a market-based system and regular devaluations reduced the premium on the parallel exchange rate from 150% in 1990 to less than 10% by the end of 1993 and averaged 13% during 1994. The metical (MT) only depreciated by 26% against the dollar in 1994 (compared to 81% during 1993), largely as a result of the infusion of funds under the World Bank's Second Economic Recovery Credit. The metical depreciated gradually in nominal terms relative to the dollar but the effective exchange rate appreciated in real terms. The spread between the official and the parallel rate declined from 19 percent in March to 10 percent in December 1994. Convergence of the official and parallel rates has proven difficult, partly because of Mozambique's extensive borders which, exacerbated by the current tax and customs regime, invites smuggling (particularly to and from South Africa) and the continued use of foreign currency as a store of value.

Significant progress was achieved in improving financial incentives. Products with fixed prices accounted for about 30% of GDP in 1989 compared with 70% in 1986. A more significant breakthrough occurred in July 1993 when the GRM decreed that prices on a large number of food goods were liberalized in the pursuit of "development of free competition in the market." Maize meal, cooking oil and rice were among the goods covered in this decree. Prices of 22 more products were freed in August 1993. Administered consumer prices are now limited to two basic foodstuffs (wheat flour and bread), rents, fuels, utilities, newspapers and certain hotel tariffs and transportation fares. The conditioned price system which applied to eight goods produced under monopolistic conditions was eliminated in April 1994. The GRM is planning to revise urban residential and commercial rents in 1995 which have been basically frozen since 1991.

Considerable fiscal adjustment was carried out and fiscal performance was better than targeted under the IMF Structural Adjustment Facility (SAF). The revenue base was strengthened with fiscal revenues increasing from 13% of GDP in 1986 to over 22% in 1990. Some progress was made in prioritizing public expenditures. The budget slowly became more coherent with national development priorities. Budgetary coverage was widened by including previously off-budget items amounting to about 10% of GDP in 1990. A rolling three year investment plan was formulated which led to a reallocation of investment towards the social sectors, agriculture and transport (away from large-scale capital-intensive projects in agriculture). To raise the efficiency of existing investment in the social sectors, recurrent expenditures were increased. The inefficient National Food Distribution System was phased out, food subsidies were virtually eliminated, and a safety net targeted to a segment of poor urban households (those without earning potential) was established in 1992.

Fiscal policy aimed at mobilizing domestic and external resources while reducing monetary financing of the budgetary deficit. The fiscal deficit before grants remained at nearly the same level (29%-30% of GDP) in 1990-1993 but the fiscal deficit, after grants, fell from 12.3% to 3.4% of GDP during the same period. However, in 1994 the fiscal position considerably weakened with the fiscal deficit, before grants, reaching 30% of GDP and, after grants, 9% of GDP. The increase in the deficit was partly attributable to: the expenditures related to demobilization, elections and the democratization process (5.7 percent of GDP); the decline in government revenues both in real terms and as a percentage of GDP (-2.4 percent); and the rapid increase in budgetary investment (4.3 percent of GDP), which was primarily externally financed.

Enterprise reform succeeded in privatizing about 370 small and medium-enterprises from 1987 to September 1994. However, reform of large enterprises moved much slower. The main burden of reforming the financial and enterprise sectors lay ahead. The main focus in the enterprise sector was on creating a clear legal and institutional framework for privatization (even if this slowed down privatization). All state enterprises with the exception of strategic enterprises that provide essential public goods and services were to be privatized, transformed into commercially-oriented public enterprises or liquidated. By the end of 1993, most state farms had ceased production or had been privatized. Progress on privatization of large enterprises, however, was extremely slow and no major enterprises were privatized during this period. The gross value of output of enterprises sold prior to 1994 was only one percent of total gross industrial output. By the end of 1993, approximately two-thirds of gross industrial output remained under the control of the state. Loss-making operations of many state firms have been covered partly through direct budgetary transfers (less than one percent of GDP), but mostly through indirect transfers. Large state industrial firms account for a high percentage of the non-performing loan portfolio of the banking system, in particular the Commercial Bank of Mozambique (BCM), the largest state-owned bank. Inevitably, this transfer of resources to loss-making state enterprises has crowded out access to credit by the private sector, further constraining industrial output recovery. However, there was an increased effort on the part of the GRM in the latter half of 1994 and early 1995 regarding privatization of large enterprises. As of February 1995, 19 large enterprises (out of a list of 56) had been privatized and 10 more were in the process of privatization, reducing the level of state control of gross industrial output to about one-third of the total.

In contrast to other areas, implementation of financial sector reform in the first few years of adjustment moved much slower than expected. Separate legislation was developed with a new Central Bank Act in 1991 and a Banking Act in 1992 which established the legal and institutional framework for prudential regulation and supervision of the banking system. The separation of the central banking functions and the commercial banking functions of the Banco de Moçambique (BM) was achieved in 1992 (as opposed to the 1990 target date). A separate commercial bank, Banco Comercial de Moçambique (BCM), was established and the staff from BM were divided between the two institutions. Regulations and procedures were issued for licensing of new banks and two private banks were licensed and began operations. Progress towards enhancing transparency of the financial system, however, revealed that severe distortions existed and there were greater imbalances in the financial and enterprise sectors than had been initially realized. Explicit budgetary subsidies to state enterprises were reduced from 8.5% of GDP in 1986 to less than one percent of GDP by 1992. However, implicit subsidies have proven more difficult to eliminate. Stricter explicit credit rules were imposed and the GRM adopted the principle that bank loans would not be granted to cover operating losses of public enterprises (following its assumption in 1987 of financial responsibility of bad loans of public enterprises--which amounted to 14% of GDP). Nevertheless, the publications of BM and BCM's accounts in 1993 revealed that substantial additional credit to public enterprises had in fact been provided from 1987-1992, with the accumulation of non-performing loans assigned to BCM (roughly 7% of GDP).

In addition, the GRM failed to effectively control monetary expansion. Part of this was related to the separation of BM and BCM, including the final assignment of certain foreign exchange assets and liabilities and the fact that BCM could not comply with the requirements of the adopted banking regulations. Other issues include the increase in interbranch assets liabilities of the two state banks and an expansion in inter-enterprise liabilities. This occurred as tighter lending criteria were adopted in 1993 and explicit credit to public enterprises was effectively stopped. Imbalances in the financial sector reflect underlying real problems in the enterprise sector. Large information gaps still exist on critical variables of enterprise behavior and efficiency. Savings mobilization has also been very poor. Financial repression has forced a great deal of financial activity into the informal sector as a result of the lack of implementation of banking system reforms, the lack of banking services and the poor returns on financial savings.

The GRM has had partial success in stabilizing the economy. The rate of inflation decelerated from 163% in 1987 to 33% in 1991, in line with tighter fiscal and monetary policies. In 1992, inflation accelerated and peaked at 55% in December 1992, mostly on account of the drought. Despite normal rainfall and efforts to eliminate various financial leakages, inflation reached 43.6% by December 1993 (well above the program target of 30 percent). The situation deteriorated significantly in 1994 with inflation reaching 70.8% by the end of December (again, as in 1993, above the program target of 30 percent). The broad money supply increased by 49 percent in 1994 with net credit to the economy expanding by 65.5 percent. Inflation through the growth of money was driven in large part by the banks not adhering to credit ceilings and an expansion in other items net. However, the central bank took stronger measures to control the money supply in the last quarter of 1994 when it began to more strictly enforce credit ceilings and charge higher penalties. The program target for inflation in 1995 is an ambitious 24 percent.

Despite the initial gains of the ESRP, deep structural problems continue to hamper

Mozambique's economy. With a per capita income of about US$80, Mozambique is one of the poorest countries in the world. Mozambique remains heavily dependent on external aid inflows and has requested $1.5 billion in assistance at this Consultative Group meeting. After elections in October, there has been a renewed effort on the part of the GRM to increase transparency and accountability as well as to significantly improve macroeconomic management.

Over the period of the CPSP (1996-2001), economic growth will probably be in the 5-6 percent range as the economy becomes increasingly more open and responds to liberalization measures and improved security. A more rapid growth may be possible once the country's human resource base has been strengthened and major industrial and service sector restructuring has been completed.

The agricultural sector will be the engine of growth during the short to medium-term. The potential for agroprocessing to contribute to growth will be significant as agricultural-related enterprises are privatized or restructured. Because about 60 percent of the population is absolutely poor, labor-intensive growth is essential for reducing poverty and increasing income. This requires in particular acceleration of growth in the agricultural sector. Given Mozambique's goods soils and ample land, there is considerable potential for increased rural incomes.

Mozambique's extreme dependency on donor aid will gradually diminish over time. The viability of Mozambique's balance of payments relies substantially on external assistance for import financing and debt rescheduling. Although Mozambique has received significant debt relief since 1987, they will continue to require special assistance over this period. Without debt relief, even assuming high levels of economic growth, viability in the short to medium-term will be difficult. Exports will have to increase substantially to overcome the current large trade deficit. As the agricultural sector responds to the improved environment, agricultural exports should increase dramatically, given the high potential that exists in this sector. This will require success in stimulating private investment and attracting foreign investment which will play a major role in increasing exports.

Mozambique will continue to need a program of fiscal austerity with concomitant tight monetary policies to control inflationary pressures. The prioritization of public expenditures and reorientation toward the private sector will play a crucial role in this endeavor. The need to broaden the revenue base becomes more urgent as donors gradually reduce their funding levels closer to the Southern Africa regional average (Mozambique currently receives almost twice the regional average) during this time period. Substantial reform of the nascent financial sector will be required in the short to medium-term.

Production and Expenditure

I. Statistical Foreword

Statistical services in Mozambique are improving but there are still significant contradictions within official sources and also between government and alternative sources. Data have been revised a number of times in recent years, with the most recent revision taking place in 1994 which retroactively modified the national accounts since 1987. Mozambique doesn't have the technical expertise and, until recently, didn't have access (primarily because of the war) to enable a sufficient mapping of areas such as output, marketing and expenditure. A note in the 1994 Economic and Social Plan (PES) by the National Planning Commission (CNP), which collects the data, stresses that, in spite of revisions to improve data coverage, there is still a very great weakness in the gathering of statistics, aggravated by, inter alia, the rapid growth of informal sector activity in recent years. The latest revision is an attempt to include estimates of informal sector activity which is thriving. The accounts now attempt to include government services (social services), retail and wholesale commerce, hotels, restaurants and cafes, business services and domestic and personal services.

The GRM is attempting to improve its statistical collection capability in concert with donor support. The GRM recently proposed the establishment of an autonomous National Statistics Institute to oversee the gathering of statistics. Several GRM/donor working groups, in addition to direct technical assistance provided by multilateral and bilateral donors, have been formed which directly or indirectly address statistical issues. The World Bank, in conjunction with other donors (principally USAID), recently formed a statistical working group to assist the GRM in improving its collection and analytical capabilities. In addition, the IMF is also extremely concerned about the situation and is planning to take additional measures (to those already implemented) to strengthen statistical capabilities in Mozambique. The GRM, after the October 1994 elections, has made a concerted effort to increase transparency and accountability and improve overall macroeconomic management.

Partly because of the lack of reliable data, the process of reform in Mozambique is not unlike one of opening up a series of black boxes with respect to information flows, and progressively turning off taps with respect to bringing monetary, fiscal and enterprise accounts under control. That said, the reader is cautioned that, at best, the data provides an indication of general trends.

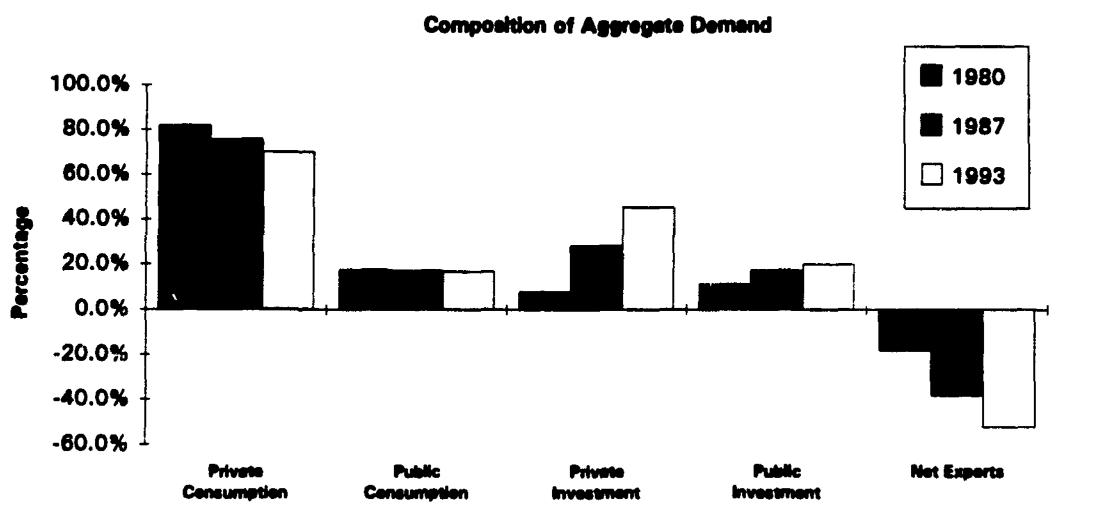
II. Gross Domestic Product[1]

[1] Data on Mozambique's national accounts is obtained on the basis of output, budgetary and trade statistics. GDP is compiled only in terms of uses of resources: consumption; investment; and exports and imports of goods and nonfactor services. The data is calibrated in line with a measure of gross output derived from sectoral developments in the economy. Intermediate consumption data is not available, which precludes any estimates of value added. Private consumption is compiled on the basis of the estimated wage bill for the private sector and estimated autoconsumption in the subsistence sectors. Gross investment excludes changes in stocks because of the lack of reliable data.

A. Structure

The structure of GDP in 1987 was significantly different from that of 1981-1986, which was characterized by lower shares of private investment as well as a smaller resource gap (the difference between exports and imports of goods and nonfactor services). Aggregate demand in 1980 was dominated by consumption expenditures with private consumption accounting for 81.8 percent of GDP and public consumption accounting for 17.6 percent of GDP. Private investment was only 7.8 percent of GDP while public investment accounted for 11.1 percent of GDP. Net exports were -18.4 percent of GDP. By 1987, private consumption had declined to 75.8 percent of GDP and public consumption only declined marginally to 17.2 percent of GDP. Private investment increased to 28.2 percent of GDP and public investment increased to 17.3 percent of GDP. Net exports fell to -38.5 percent of GDP. The 1987 structure represented the transition between the closed structure of the first half of the 1980's and the emerging structure thereafter[2].

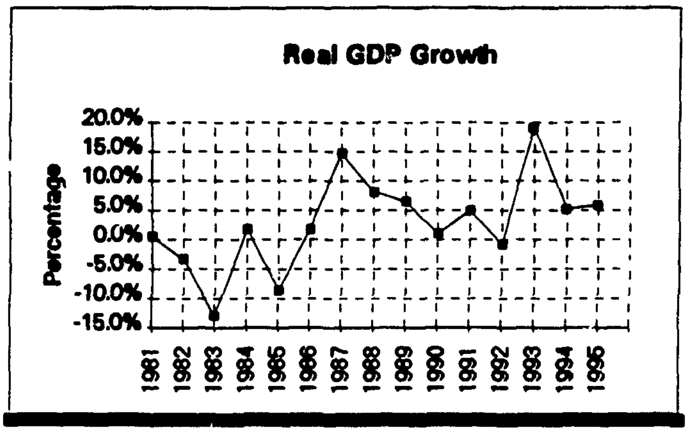
By 1993, private consumption decreased to 70.2 percent of GDP, reflecting declines in real income, and public consumption marginally decreased to 16.8 percent of GDP. Private investment increased to 45.4 percent of GDP while public investment increased to 20.1 percent of GDP. Net exports, reflecting the widening trade gap, decreased to -52.5 percent of GDP. Mozambique's inability to use its own funds for imports is clearly indicated in the 1993 export to import ratio, which stood at 13 percent in U.S. dollar terms (14 percent in 1994).



2 In assessing the increased degree of openness of the economy since 1987, it is important to note the bias of time series of ratios to GDP in Mozambique before and after 1987. The deflators of GDP and its domestic components increased much less rapidly than did import and export prices in 1987-1989, when significant exchange rate devaluations took place. Therefore, the external component of GDP measured in domestic currency revealed a wider gap after 1987, given the fact that exports were much smaller than imports. In addition, the marked increase in the share of investment in GDP reflected in large part its high import content, which was converted into domestic currency at a much more depreciated exchange rate from 1987 onward. Public consumption, on the contrary, was less affected by the devaluations because it consists of wages of civil servants, which have lagged far behind the rate of devaluation.

B. Performance

Production dramatically collapsed between 1981-1986. This period was characterized by a marked fall in output, an aggravation of economic distortions and financial imbalances, an expansion in parallel markets and a rapid accumulation of external debt. The poor performance was due to a variety of factors, including a series of domestic and external shocks (droughts and floods, the diversion of South African traffic from Mozambique railways and ports and reductions in the number of Mozambican miners in South African mines), inappropriate macroeconomic and sectoral policies, and the effects of the war. Real GDP declined at an annual average rate of 3.5 percent per year. Consumption declined by an annual average of 6.4 percent while gross investment increased by only 0.4 percent per year. Net exports declined by an annual average of 6.2 percent in real terms over the same period.



The positive performance of output, consumption and investment since 1986, and especially 1987, marked a significant departure from the declining trends that caused GDP to plunge during the first half of the 1980's. After partial implementation of economic reform in 1986, the economic collapse that dominated the first half of the 1980's was arrested during the first three years of the ERP (1987-1989). From 1987-1991[3], annual real GDP growth averaged 9.8 percent, private consumption averaged 8.8 percent, gross investment averaged 10.4 percent and net exports averaged 20.2 percent. Relative to the earlier decline, this reversal was a major achievement. However significant, given the depth to which real incomes and production had fallen, this growth rate represented only a modest upturn. Real GDP in 1986 was only about 73 percent of its 1980 level.

Real GDP fell 0.8 percent in 1992 because of the drought and a slowdown in industrial activity. Agricultural output plunged, in particular subsistence crops. Maize production in 1992 only reached one-third the crop level of a normal year. All GDP expenditure components fell in 1992 except for public consumption which increased by 8.9 percent, largely as a result of the emergency expenditures related to the drought. Private consumption declined by 3.2 percent in real terms between 1990 and 1992, largely due to the declines in real wages that followed price liberalization and the drought. Public investment declined as a result of the GRM's effort to

[3]The relatively good performance of GDP in 1991 was largely due to a surge in merchandise exports that reached $171 million, on account of both increased volumes and favorable terms of trade.

streamline their investment activities and better target their projects but also due to the change in composition of external aid to meet the requirements of the drought. Imports of goods and nonfactor services declined by 5.9 percent in real terms (reflecting the slowdown in economic activity and domestic demand), while exports of goods and nonfactor services fell by 1.2 percent from their 1991 level.

As the country responded to preace and recovered from the drought, real GDP in 1993 grew by 19.2 percent[4] (with per capita income increasing to $80, still the lowest in the world). Private consumption increased by 21 percent in response to the end of the drought, the establishment of peace and increased demand for services related to the expanded activities of the United Nations peacekeeping force in the country. The boost to production came mostly from growth in the agricultural sector (27.4%), which benefitted from the end of the drought, good rains and improved security. Industrial production continued to decline in 1993 partly due to the continued slow pace of restructuring large state-owned enterprise. Transport activities continued to increase rapidly, partly because of a sharp recovery in international transit, partly because of movement of food aid, and increased economic activity (rail freight increased by 30 percent from 1991, when activity plummeted). Commerce activities recorded a substantial increase as a result of increased imports and domestic sales of commodities. Economic recovery continued in 1994 with a real growth rate of 5.4 percent (excluding trade, the growth would have been 7.7 percent in real terms).

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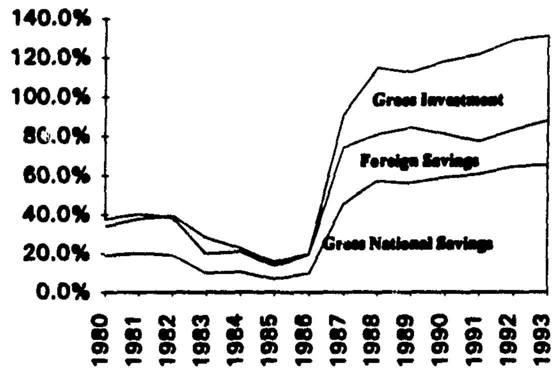
[4] In addition to the recovery from a low base the authorities revised the national accounts in 1994, retroactive to 1987.

III. Savings and Investment[5]

The savings-investment ratios of Mozambique reveal profound macroeconomic imbalances. The private sector[6] appears consistently as a sizable net dissaver while the external sector provides the bulk of resources for domestic investment. The economy will be in no position to generate sufficient domestic savings to finance investment in the short to medium-term even assuming an accelerated expansion in GDP. In view of Mozambique's extremely low levels of per capita consumption and incomes, negative private sector savings, equivalent to over 13 percent of GDP in 1993, cannot be reversed in the medium-term. However, on the revenue side, there is ample room to broaden the relatively narrow, small tax base. In particular, there is room to greatly increase customs revenues. Given the enormous needs of the country, it will be difficult for government to further reduce expenditures. However, there is an opportunity for the GRM to reorient their expenditures, particularly from defense and security expenditures toward social sector expenditures.

Savings and Investment (% GDP)



The surge in the ratio of investment to GDP is largely related to the link between foreign aid and investment outlays and by the effect of currency depreciation of prices of investment goods. The ratio of investment to GDP increased from 45.5 percent in 1987 to 65.5 percent in 1993. Foreign savings[7], after steadily declining from 28.1 percent of GDP in 1989 to 16.5 percent of GDP in 1991, increased to 22.3 percent of GDP in 1993. The ratio of transfers from abroad, which were predominantly grants, experienced a fivefold increase during the same period, which largely offset net factor payments to abroad (increasing by the same token the dependency upon foreign aid). The breakdown of the global savings-investment picture in sectoral financial balances reveals deep

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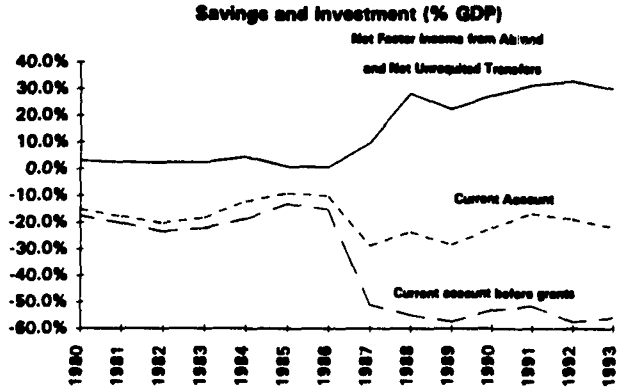
[5] In the absence of national accounts income data, savings are computed based on national accounts expenditure data and cannot be checked for consistency with income data. In the absence of data on capital depreciation, it is only possible to analyze gross rather than net savings. Gross domestic savings is defined as the difference between GDP and total consumption. It is equal to gross investment plus the current account of the balance of payments minus net factor income from abroad and net unrequited transfers.

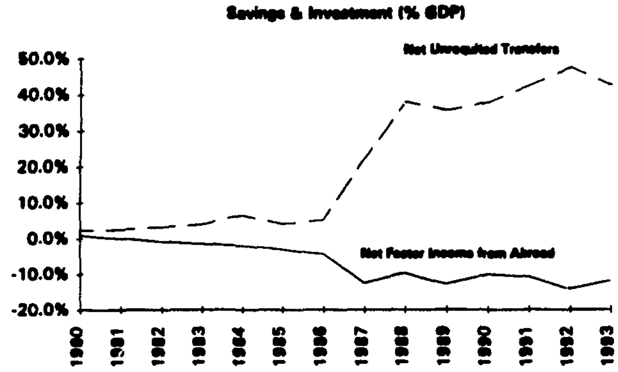
[6] These numbers are derived as the residual from the savings/investment balances and thus contain errors and estimation problems. The numbers have a high margin of error due to the way they are estimated (as residuals from other numbers that are problematical). The negative private savings rate reflects extremely low levels of per capita consumption and income, inefficiencies in the banking system and the poor services they provide, i.e., a situation of extreme financial repression. The financial system plays only a small role in allocating financial resources. A large proportion of activity takes place in the informal sector. The current commercial bank deposit structure leans heavily toward demand deposits which constitute 92 percent of the deposit base. High levels of liquidity and the subsequent redepositing of excess funds in the central bank, at no interest, provide little incentive to mobilize term deposits.

[7] Symmetric to the current account of the balance of payments.

imbalances in both the private and public sectors, with an improvement in the public sector and a sharp deterioration in the private sector since 1987. The public sector improvement primarily comes from a large increase in official grants.

The overall availability and uses of resources further illustrates how growth has been financed by external resources. The sectoral breakdown of the global savings-investment balances shows that during 1989-1993, public sector savings improved from 19.6 percent to 24 percent of GDP in 1993, principally due to the rising unrequited transfers from abroad. Unrequited transfers from abroad were a major source of resources, especially for the public sector, as they reached 42.2 percent of GDP in 1993, and more than offset rising net factor payments to the rest of the world. Meanwhile, private sector savings remained negative, although improving somewhat from -13.1 percent in 1989 to -9.6 percent of GDP in 1993[8], primarily reflecting the financial repression in the banking system and increased activity in the dynamic informal sector.





[8] It is difficult to ascertain the extent of capital flight, given the absence of reliable data and the magnitude of informal sector activity. One source of capital flight, overinvoicing imports, does not appear to be taking place. On the contrary, as illustrated in the chapter on public finances, massive underinvoicing of imports appears to be taking place as importers seek to avoid high tax and customs payments.

IV. Gross Output[1]

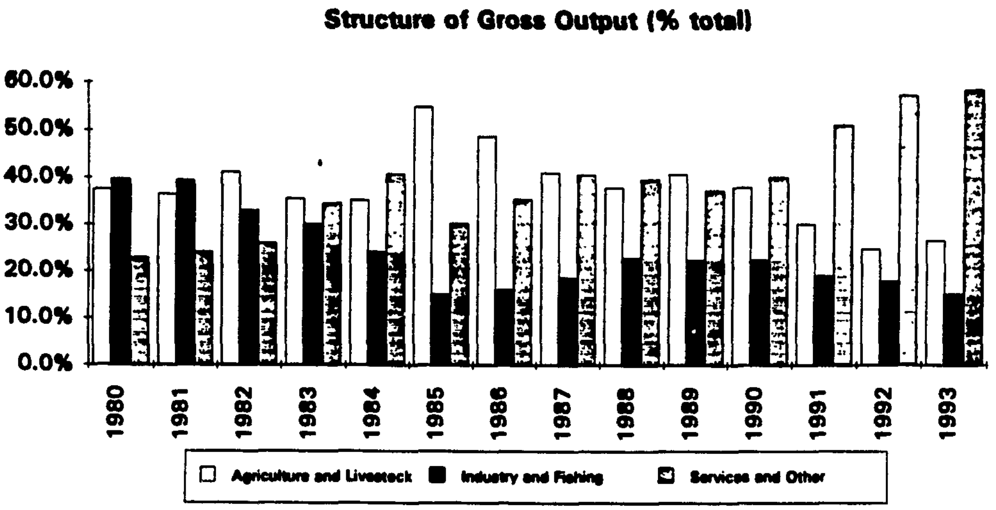
A. Structure of Gross Output

Gross output during 1980-1989 was largely determined by developments in agriculture, which is the most important sector in the economy[2], although its relative weight has gradually declined and amounted to 26.5 percent of total output in 1993[3]. Over the same period, the industrial sector continued a long downward trend. The increase in the relative importance of services throughout the 1980's was mainly due to the increased share of construction, and, more recently, to the increase in commerce and transport as the economy has increasingly become more open and received more donor support. Overall, output has been affected by the level of insecurity in the country, a host of natural disasters and inappropriate economic policies.

[1] Gross output measures the gross value of transactions as opposed to value added. It includes only the production of goods and material services but not such activities, until recently, as banking, education, health, public administration and informal sector activities. It is compiled in both current and constant prices. Official sources do not provide data on GDP by origin, which is partly a vestige of the days of Soviet influence on statistical presentation. Overall, the figures do not correspond closely to GDP components.

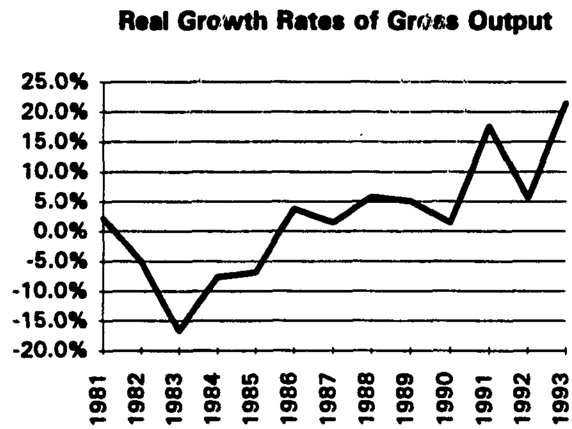
[2] Agriculture is the most important sector in the economy. The way the agriculture sector is defined in the Mozambican accounts does not incorporate agro-processing activities or commercial fishing, two significant agriculture-related activities. The agriculture sector, broadly defined, accounts for about 60 percent of GDP, 80 percent of employment and 80 percent of foreign exchange earnings.

[3] Gross output involves a lot of double counting since it cumulates the value produced by input sectors. Therefore, it is not entirely meaningful to compare gross output by sector, e.g., see footnote 2.



B. Performance of Gross Output

Real gross output declined an average annual 5 percent between 1981 and 1986. All sectors declined during this time period. Output plummeted from 1980-1983 as a result of a large increase in war activity, a major drought, marketing bottlenecks and very low producer prices. Agricultural and livestock production declined by 3.4 percent per annum over this period. Industrial and fishing production declined by 12.4 percent per annum. The service sector declined by 1.8 percent (transport alone declined by 8.3 percent). Within the services sector, construction registered the only positive increase, averaging 5.7 percent per year. After the implementation of the ERP in 1987, gross



output increased 4.2 percent per year from 1987-1989. All sectors recorded positive rates of growth (in the services sector, construction declined by 4.3 percent per year). Agriculture and livestock production increased by 6.1 percent during this period and industry and fishing increased by 7.6 percent per year. Service sector output only increased by one percent, largely due to continuing instability and the lagged response in improved market conditions.

During 1990-1992, real gross output increased 8.2 percent per year, although agriculture and livestock declined by 4.8 percent per year, largely because of the drought. Agricultural output declined by 9.9 percent in real terms in 1992[4]. Industry and fishing declined by 4.6 percent per year from 1990-1992, as the industrial sector continued its downward path. The services sector grew at an annual average rate of 24.4 percent, largely fueled by an increase in commercial activities and transport services in responding to increased urban demand and the donor response to the drought.

In 1993, real gross output grew by 21.5 percent, after a drought-affected decline of almost one percent in 1992. This growth was spurred by increased agricultural production (an increase of 27.4 percent) and services (particularly commerce), which benefitted from increased security, the return of refugees and displaced people, and an increased demand for services linked to the United Nations peacekeeping force in the country. The growth in agriculture and livestock reflected good rains and a concomitant improved harvest in 1993. Thus, all sectors grew rapidly except industry and fishing which increased at only 2.3 percent, partly due to strong import competition as a result of inadequate border controls, the loss of the former Soviet Union market which continued to be a major setback to domestic textile producers. and the relative inefficiencies of large industrial enterprises, the majority of which were controlled by the State.

In 1994, continued growth in output accelerated to 5.4 percent as a result of improved security, better weather, partially restored infrastructure and continued structural reform. At the heart of the increased level of output was agricultural growth, especially increased agricultural marketing and improved security which led to more commercial activities in rural areas. As a result of the reconstruction of road and rail links throughout the country as well as private home construction, the construction sector expanded at a real rate of 7.5 percent in 1994. In contrast, however, the industrial sector continued to decline for the fifth straight year in a row.

C. Agriculture[5]

Agriculture is the main pillar of the Mozambican economy. Agricultural output consists mainly of subsistence production, which accounts for over four-fifths of the total. Liberalization measures undertaken since 1987 under the ERP have been instrumental in the recovery of the

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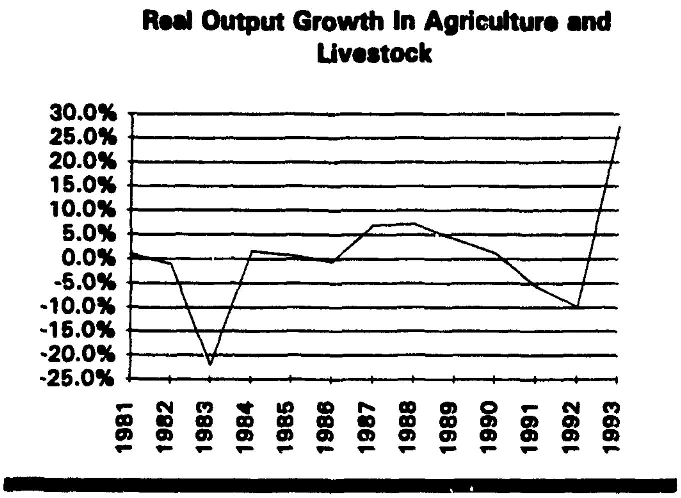
[4] Marketed production, however, accounts for most of the fluctuations in the growth rates.

[5] Figures for officially marketed production do not capture output commercialized through the black market and the less tightly controlled producers (mainly women) in the green zones around the periphery of Maputo and Beira.

sector but deep structural problems remain to be addressed.

Agricultural output fell dramatically during the first half of the 1980's as a result of the armed insurgency, a series of natural disasters (particularly a severe drought in 1983), the increasing centralization of agricultural activities, and rigid policies of administered producer prices. Prices were set on a pan-territorial basis and were left unchanged for long periods of time (as the commodity-specific graphs indicate in the following section). During 1981-1986, although the subsistence sector proved rather resilient, the decline in the agricultural sector was severe. By 1985, cotton and sugar had collapsed to 9 and 16 percent, respectively, of their 1980 levels. The production of tea and cashew nuts, which together contributed a third of the country's total export earnings, fell to around 30 percent of their 1980 levels. Between 1981 and 1986, the marketed production of maize and rice declined by about 50 percent. Although it is difficult to assess the production of subsistence agriculture, it is estimated that climatic problems and the massive displacements of populations led to a substantial decline in food production and that per capita food production in the subsistence sector may have fallen by as much as 30 percent between 1981 and 1986. As a result, the country became heavily dependent on foreign aid to guarantee a minimum level of food security to its population in urban centers and in some rural areas. Investment also declined, reflecting the fall in non-food external assistance as the composition of foreign aid changed to meet food security needs.



In addition to the insecurity caused by the war and periodic natural disasters, the attempt to promote rural development based on an Eastern European model centered on large State farms and centralized resource and staff allocation and pricing had a deleterious effect. Available capital was concentrated in low productivity State farms. Family sector production for the market declined significantly in the face of fixed prices and lack of goods to buy in rural areas. Efforts to organize the rural population in communal villages had a disruptive effect. By 1982 nearly 20 percent of the farm population lived in these villages. However, most villages produced little, if anything, on a communal basis. Family plots remained the preferred unit of production. The lack of incentive for communal production was exacerbated by government inability to provide needed inputs or services on time. Most government services, particularly provision of inputs, were destined for large State farms. Reversion to subsistence production occurred on a widespread basis as the crop marketing network failed, which resulted in a marked decline in marketed surplus. The failure of State farm production is a testimony to the effectiveness of guerrilla raids against such concentrated targets as well as the inefficiency and high capital costs of these production units.

As can be seen below, the high priority given to setting of prices on a pan-territorial basis contributed to a significant decline in production. The relative terms of trade for rural producers declined drastically in the 1980's. However, even before the years preceding the sharp rise in inflation, the purchasing power of the metical had dropped in rural areas more as a result of the extreme scarcity of goods to buy than as a result of price inflation per se. When goods were available, they were often sold outside official channels at prices well above official levels. By the mid-1980's it was increasingly obvious that the GRM policy emphasizing increased production in the state sector had failed. The system of fixed prices for agricultural products gradually eroded incentives for marketing output from the smallholder sector (which accounted for more than 75 percent of the population). The extreme scarcity of consumer goods in rural areas also represented a significant constraint to the effectiveness of price incentives. Although the ERP initially addressed some of the constraints, e.g., relinquishing direct administrative control of much of agricultural production and marketing system, the GRM remained committed to centralized distribution of consumer goods and government-guaranteed markets for smallholder production (partly because the security situation prevented private reestablishment of the rural trading system). An anti-private philosophy and its accompanying regulatory framework, together with the lack of capital and the high risk (and low return) relative to rural trading prohibited private sector expansion into trading and distribution.

Exacerbating this trend, the GRM set ceiling prices on consumer goods, creating as much of a disincentive, if not a greater one, to increased farm production because of the resulting shortages. For much of the 1980's, urban consumers were issued ration cards to buy consumer goods which, due to chronic shortages of consumer goods, increased activity in the parallel markets.

With the ERP, however, the government successfully attempted to restore price incentives for agricultural production, resulting in substantially higher producer prices in both nominal and real terms. The change in the trend of producer prices is readily evident in the graphs below. Policy reform led to a significant realignment of incentives away from food crops and toward export crops. The real prices of principal agricultural crops suffered both in absolute terms and also relative to important food crops before 1987. Adverse incentives contributed to the drastic fall in marketed production. For example, incentives were very poor for cashew production, which was predominantly a smallholder crop and represented a significant source of income for hundreds of thousands of smallholders, with the result that production declined as the harvest was neglected or left to children to harvest while adults worked to grow food crops for subsistence consumption.

The initial response of the economy to the ERP was very good. From 1987-1989, real agricultural output grew at 6.1 percent per annum. Agriculture and livestock production growth decelerated to 4.8 percent per year during 1990-1992, largely because of the drought in late 1991 and 1992 but also because of continuing bottlenecks in marketing and relatively low producer prices. Agricultural output declined by 9.9 percent in real terms in 1992 (autoconsumption is estimated to have decreased by 7 percent, or almost 10 percent in per capita terms, in 1992). The drought also contributed to a decline in other agricultural production (an estimated 18 percent decrease) while the impact on livestock production was an estimated 14 percent drop in output in 1992. The only bright spot in 1992 was the slight increase in commercialized production of the family sector (smallholders) that was made possible in certain areas of the country by the cessation of the war during the latter part of the year. The agricultural season of 1991/1992 is likely to be remembered in Mozambique as one of the worst ever because of the drought. Rainfall never arrived during the rainy season in late 1991 and was virtually nonexistent during the first eleven months of 1992. The lack of rain hurt the entire country but the north and central regions were hit especially hard. Rainfall resumed its normal pattern very late in the 1992/1993 growing season.

A strong recovery in the agricultural sector took place in 1993 with total agricultural output increasing by 27.4 percent. Marketed maize output reached 128,750 tons, 35 percent above the 1991 level. Other marketed food crops produced by the smallholder sector such as beans, millet and cassava also increased above 1991 levels. However, agriculture exports suffered from declining commodity prices over the 1992-1993 period, particularly for cotton (44 percent) and copra (27 percent). Agricultural and livestock production increased in 1994 but at a lower rate of growth. In March 1994, Cyclone Nadia hit Mozambique, especially Nampula Province, which is a major production area for cashews. Maize and cassava production were also affected, to a lesser extent.

Although greater encouragement has been given to foreigners to involve themselves in Mozambican agriculture, by 1994 the majority of foreigners involved in agriculture were still those working on projects funded by international donor agencies and charities, rather than representing productive investments of private companies. Uncertain land ownership laws, political tensions, and the pre-election nervousness of many prospective foreign investors (including many South Africans) were all holding back the regeneration of commercial agriculture. Lonrho, a British multinational company, in addition to JFS and Entreposto, has, among other activities, farms in several regions of the country through its agricultural joint venture Lomaco. The company has steadily increased its output of most crops since 1985 (aided in the war years by the maintenance of private militias to guard production). However, they have not made large productive investments due to the uncertain environment in which they have operated.

Overall, it is clear that the restoration of price and material incentives through the ERP for agricultural production has been effective in terms of supply response. The active decision to restore price incentives (through gradual removal of administrative controls and exchange rate devaluations) to reactivate production was a necessary condition for resources to flow where newly restored price incentives directed. Prices had been fixed at low levels with government subsidies with few major changes until the ERP. Prices for some crops had remained fixed in nominal terms for periods as long as 9 years. Restoring price incentives remains an important element to providing incentives to increase production (e.g., although producer prices have increased significantly over the years for cashew nuts, producers only received 13 percent of the world market price at one point in 1994). However, as the following commodity-specific graphs illustrate, price incentives alone were not enough to significantly restore production. In addition to the severe impacts of the war and periodic natural disasters, the lack of marketing infrastructure, which was largely destroyed during the war, has clearly had an impact on agricultural production. The following graphs mask regional variations, e.g., there were significant food surpluses produced in 1991-1992 in parts of the more fertile, better rainfed north, while the south and center of the country bore the brunt of the drought.

The development of a new strategy for agricultural growth has been obscured and, to some extent, overwhelmed by the emergency situation characterized by civil war and prolonged drought. Exports were weak in 1992-1994 and the country continues to be dependent on donor support for its food needs. What marketable surplus is produced has often not been transported to the regions where it is needed, because of high transportation costs imposed by wartime damage to infrastructure and insecurity. Apart from improved climatic conditions, the substantial increase in agricultural marketed output surpluses in 1993, an increase of 26 percent in the family sector, was chiefly due to the onset of peace, the return of refugees and the distribution by aid organizations of seeds and tools. Despite the above-mentioned conditions, there is increasing evidence that agricultural markets are gradually beginning to work in Mozambique as the liberalization process moves forward.

1. Forestry

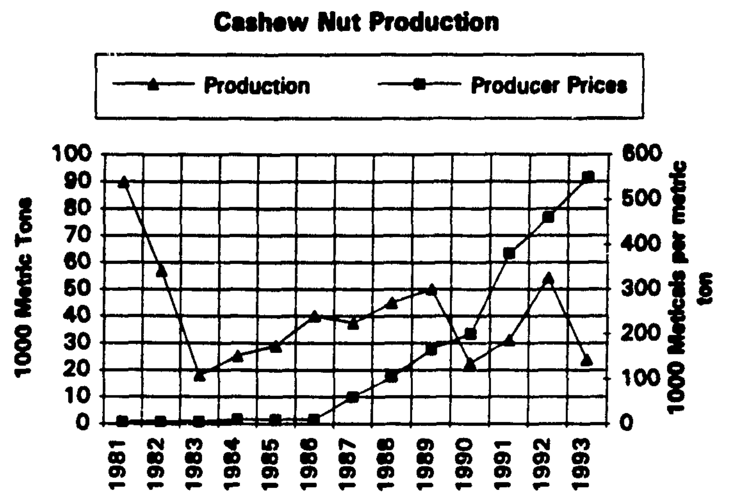
Mozambique has about 19 million hectares of productive woodland, from eucalyptus and pine (widely used for fuel and furniture-making) to rare hardwoods. Timber was a major export during the colonial period but exploitation was inefficient and undertaken on a random, unplanned basis by small sawmills. There were no reforestation programs. At independence, there was no inventory of national forest resources and not a single trained Mozambican working in this area. Today the forestry potential of the country is clearer, provincial forestry enterprises are being established, reforestation programs are being planned and the role of the private sector more clearly defined.

Nonetheless, timber production has declined in recent years primarily because of the poor security situation in the countryside. Output of logs fell from 110,900 cubic meters in 1986 to 43,300 cubic meters in 1988 before increasing slightly in 1989-1991 and falling again in subsequent years to 18,537 cubic meters in 1993. National timber export earnings (from logs, sawn wood, panels and parquet) have also fallen, from $1.26 million in 1988 to $690,000 in 1991, although private production and sales have increased.

The Ifloma project in Manica Province is the largest timber project in Mozambique. Its annual capacity is 26,000 cubic meters of sawn timber and 20,000 cubic meters of particle board. At present it is producing well below capacity. Ifloma was totally financed by the Swedish development agency (ASDI) until recently. It is in the privatization process but progress has been slow due to financial difficulties and lack of markets. Various South African companies have entered into management and rehabilitation agreements with Mozambican sawmills since the late 1980's.

2. Marketed Production of Major Commodities

a. Cashew Nuts

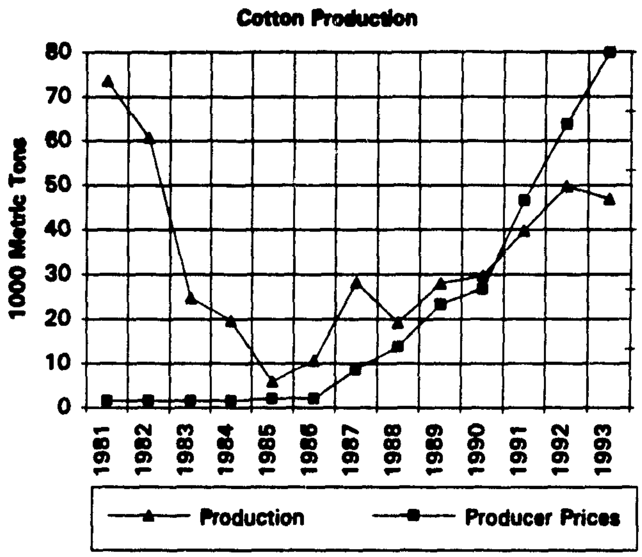


In the early 1970's, Mozambique produced more than 40 percent of world output of raw cashew nuts, reaching a peak of 216,000 tons in 1972. The departure of Portuguese traders and managers, increased war activity, declining real producer prices, and high transport costs led to the collapse of the sector in the early 1980's. Production of cashew nuts, the leading export crop, plummeted from 1980 to 1983, from 87,600 tons in 1980 to only 18,000 tons in 1983. In 1984, producer prices doubled and production increased by 39.8 percent. The production of cashew nuts increased substantially between 1987 and 1989 - from 37,500 tons in 1987 to 50,200 tons in 1989 - largely in response to improvements in the marketing system and major increases in nominal producer prices during 1987-1989 . Production was down by 55 percent in 1990 because of the war, adverse weather and relatively low producer prices despite a price increase for the 1990 crop season of 21 percent (which was only about half of the average inflation rate). Production of cashew nuts increased 74 percent in 1992 in response to sharp increases in producer prices which more than doubled since 1990. However, for 1993, output was hampered by the lagged effects of the drought. In addition, export volumes in 1993 of cashew nuts contracted by 40 percent because of diminished activity by Caju de Mocambique, the state cashew processing parastatal, which was undergoing privatization. Although some exports of unprocessed cashew were permitted, the overall value of cashew exports in 1993 was still below that of 1992. Overall, cashew nut production has been hampered by heavy state intervention in pricing and marketing policy as well as the war and cyclical natural disasters. Basically, minimum producer prices and export restrictions have been used to ensure cheap supplies of raw nuts to inefficient local factories.

Cashew nut production declined further in 1994 largely due to the destruction caused by Cyclone

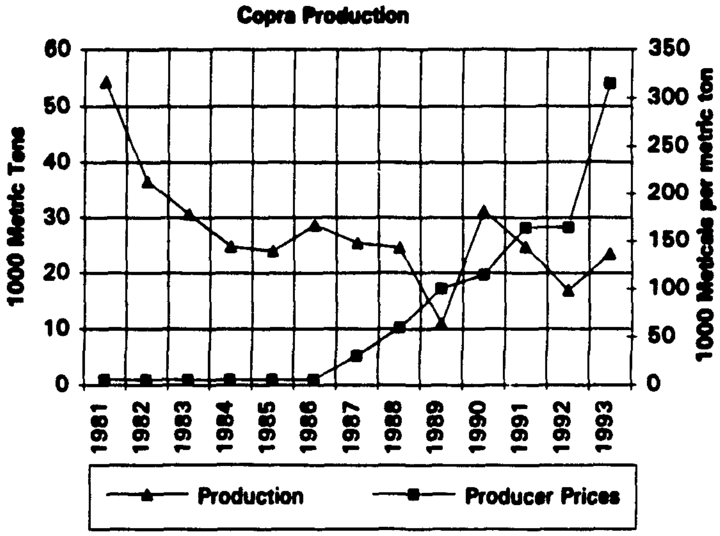
Nadia in Nampula province (which produces 70 percent of cashew nuts in Mozambique). Mozambique currently has a national orchard of about 30 million trees, most of which are beyond their productive age and provide low yields. This translates into a maximum potential capacity of 80,000-90,000 tons per year, less than half the pre-independence peak. Overall, world production of raw nuts has declined since 1974 when it reached a peak of 470,000 tons, and is presently around 400,000 tons. Combined with the fact that cashew faces a high income elasticity of demand, the world price of cashew nuts has remained strong. While the two leading African suppliers, Mozambique and Tanzania, have steadily lost world market share since the early 1970's, India and especially Brazil, have increased their production almost every year. Collectively, these two countries presently supply about 80 percent of world cashew production.

b. Cotton



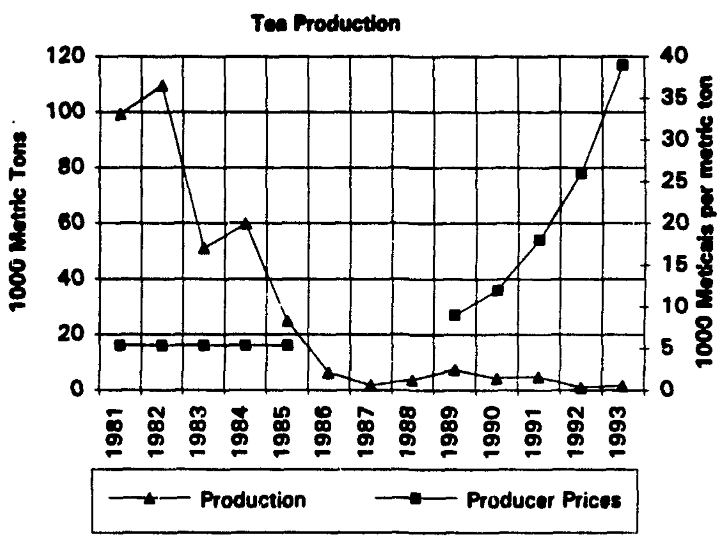
Production of cotton, another key crop, drastically declined during the early 1980's but jumped to 28,000 tons in 1987 and returned to that level in 1989 after a poor season in 1988. The sector was substantially restructured after 1988. Land of the loss-making parastatal companies, which owned five mills and a large acreage, was distributed to the family (smallholder) sector. Three of the five mills were transferred to the private sector. Unlike many other commodities, the GRM entered into joint venture agreements with a number of private sector firms in the cotton sector. The GRM provides large tracts of land on a 25 year lease basis while the firms provide management expertise, equipment, capital and marketing connections for the business. As long as world prices are attractive, it will be difficult for JVCs to maintain monopsony cotton purchase rights in their concession areas. Area planted to cotton by smallholders is expanding and for many smallholders in particular geographic areas, cotton is a major source of cash crop income.

c. Copra



Copra output declined during the 1980's. Output, which had declined sharply in 1989, recovered considerably in 1990 (184 percent increase) but weak export prices offset the partial upturn in shipments. The main factors behind the recovery were improved security conditions in the copra regions in Zambezia province and increased output of the smallholder sector in Inhambane province. Copra output fell sharply in 1991 (21 percent) and 1992 (32 percent) but recovered in 1993 (increasing 39 percent).

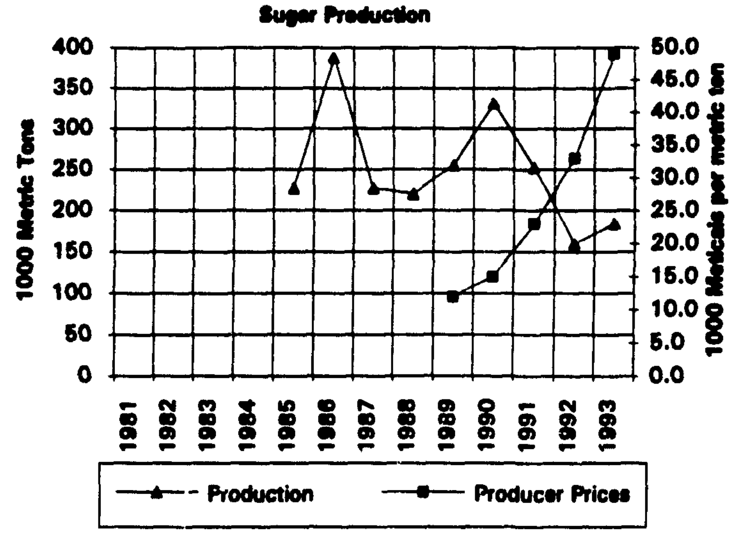
d. Tea



Production of tea, which was a particularly important export crop before independence, declined drastically during the 1980's and early 1990's. Due to their location, the large state plantations were an easy target for the guerrillas during the war and production has never recovered. Production increased in 1988 (11 percent), although it was still less than 40 percent of the output level of 1985. After a brief recovery in 1991, production fell sharply in 1992 to 1,000 tons from already depressed levels as plantation fields were left untended. Production increased slightly in 1993 to 1,700 tons. Tea exports were limited to existing stocks of low quality aged tea leaves. Significant replanting of the orchard base is needed as well as large scale rehabilitations. Only two of the twenty factories run by EMOCHA, the state holding company, are operational. EMOCHA is in the early stages of privatization. The estimated cost of rehabilitation is around

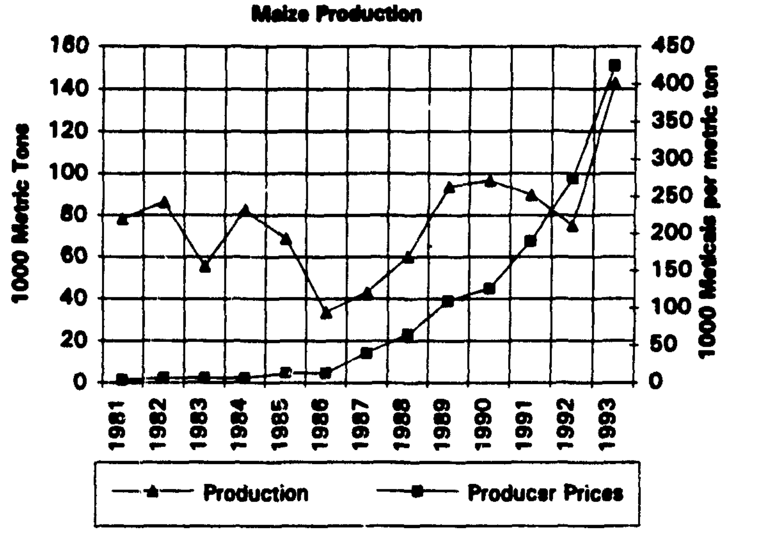
$40 million.

e. Sugar



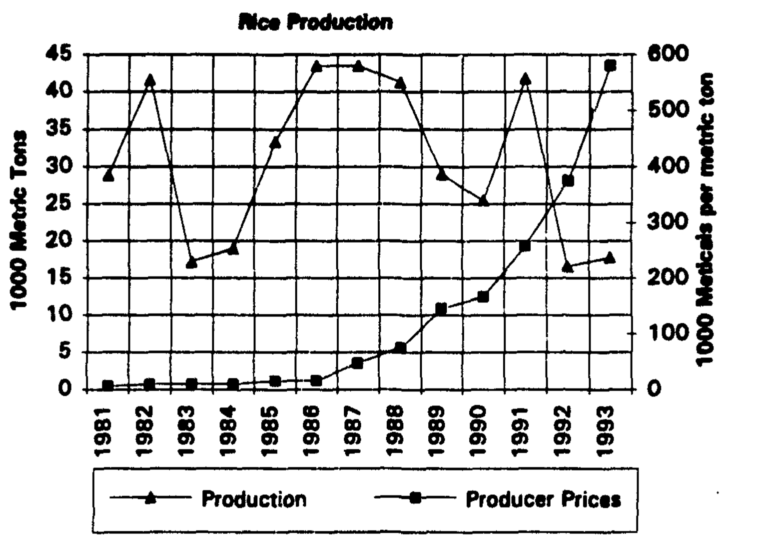
Production of sugar was concentrated during the 1980's in state farms. Like tea, sugar was also an easy target for guerrillas and the sugar plantations were largely destroyed during the war. Production of sugar recovered in 1986, although the sugar companies (two state-owned and one private) were operating below full capacity, had high amortization costs, were undercapitalized and were badly-equipped (e.g., tractors were old or nonexistent). Installed capacity for the whole industry in 1990 amounted to 140,000 tons, of which 60 percent referred to the three operating companies. At the time, Mozambique benefitted from a quota agreement with the United States at an export price of about $0.22 per pound (they also had a similar agreement with the EC). Sugar production in 1992 was also seriously curtailed by the drought, falling 37 percent, after the 24 percent decrease in 1991. The sugar companies continue to operate below full capacity, despite the fact that Mozambique enjoyed full access at preferential prices to the U.S. and EC markets under quota agreements. The financial situation of the sugar companies has deteriorated and their production lines have not been upgraded (they are currently under consideration for privatization). Large investments are required to restore irrigation systems and processing capacity. At present, the rehabilitation cost of the three state-owned factories is estimated at $170 million (some of the estates are in the final process of rehabilitation), which if implemented could expand output to 120,000 tons per year, more than enough to cover domestic needs and the export quota. However, in order to compete with imports in the domestic market, sugar factories will have to reduce production costs, which in the past few years have exceeded even the preferential quota prices. Because of this, Mozambique has resorted to importing sugar to meet domestic consumption needs (about 50,000 tons per year) and to meet its export quota to the U.S. (15,000-20,000 tons per year) which is subject to preferential prices.

f. Maize



Production of maize, the most important food crop, is almost all grown by the smallholder sector. This sector was remarkably resilient during the 1980's, considering the overall effect of the war, periodic natural disasters and inappropriate economic policies. Output was limited to a 4 percent increase in 1990 mainly because of bad weather in the provinces of Maputo and Cabo Delgado. In 1992, maize marketed production decreased by 16 percent. Maize output reached 142,700 tons in 1993, an increase of 90 percent over 1992.

g. Rice



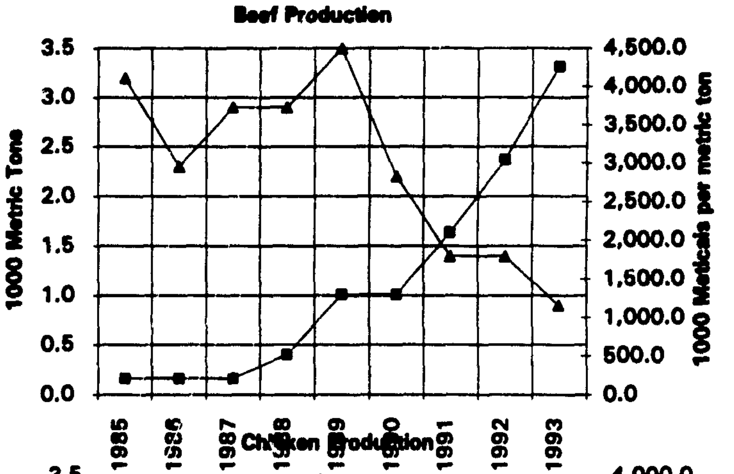
Rice production, like maize, was also fairly resilient during the 1980's. During the 1980's, the state farms collapsed, irrigation systems collapsed and structural and institutional constraints reduced production other than subsistence farming, mainly in the Zambezia and Sofala provinces. After a continual decline in production from 1987 to 1990 (the bad crop in 1989 was caused by floods), production recovered in 1991, increasing 64 percent. Production fell by 60 percent in 1992 because of the drought and the financial difficulties of the rice processing companies (one had its energy supplies cut off for lack of payment). Production increased by 7.2 percent in 1993.

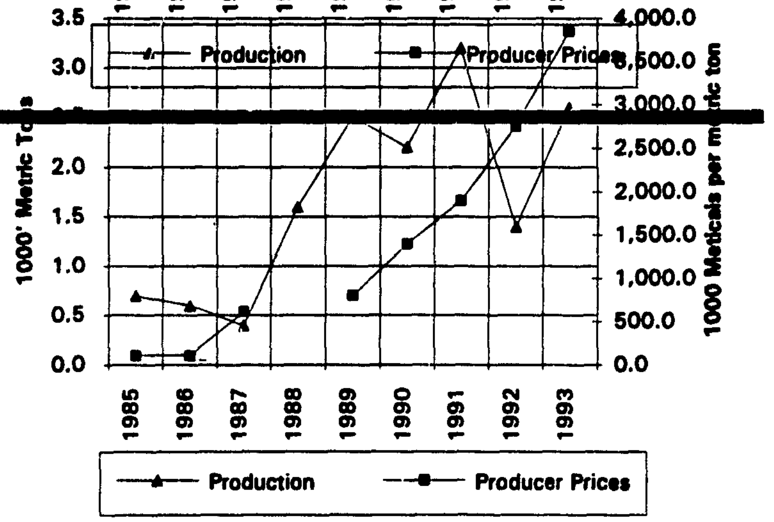
h. Livestock

In addition to the war and periodic natural disasters, prices and the marketing network during the 1980's and most of the early 1990's were not conducive to increases in livestock production. Intensive production of pork and chicken competed with human grain needs and was based on imported maize (whose price did not reflect the relative scarcity of the product because of large foreign aid supplies). Estimated per capita consumption of meat for Mozambique in 1992 was only 55 percent of that consumed in 1981. In 1992, Mozambicans consumed 1.2 kg/person and only 52 percent of that meat was produced in the country. Prices of meat products were all liberalized since 1990, which created the conditions for production to be more responsive to demand. In conjunction with liberalized prices, the end of the drought and the signing of the Peace Accord contributed to an overall increase in total livestock production of 116 percent in 1993.

i. Beef

The major livestock is beef but was greatly affected by the war. Some esuimates put the cattle stock at the level it was half a century ago. After consecutive years of decline because of the war, the drought further reduced the beef cattle herd in Mozambique to levels not recorded since the beginning of the century as slaughter of healthy animals was speeded up to avoid losses by starvation and dehydration. Beef production has continually declined since 1989.



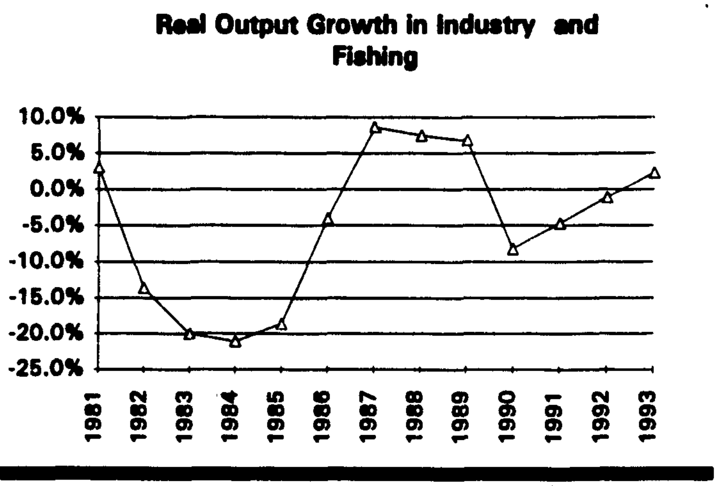


ii. Chicken

Poultry production, after declining in the mid-1980's, increased significantly in 1988 (300 percent), 1989 (56 percent) and 1991 (46 percent). Production was devastated by the drought in 1992, recording a 56 percent decrease, with egg production falling by 82 percent. Given the shorter life span of chickens, production recovered in 1993 by 86 percent with egg production increasing by 332 percent.

D. Industry and Fishing

The decline in industrial production in the immediate post-independence period was exacerbated by sabotage of infrastructure as a result of the Frelimo-Renamo conflict. Combined with the world recession in the early 1980's and the increasing centralization of production, distribution and pricing (which prevented enterprises from adapting to adverse conditions), industrial production declined sharply from 1981-1984 before increasing in 1985. As many as 254 out of 575 registered companies were either state-owned or state-operated by 1984. Despite large investments undertaken in the early 1980's (e.g., state farms, iron, steel, aluminum, chemicals and textiles), industrial output suffered a severe setback during this period because of the war, inadequate incentives provided under the centrally-planned system, and lack of foreign exchange to import spare parts and raw materials. Output in 1986 was less than half its 1980 level and one third of its pre-independence level. During the 1980's, the industrial sector was characterized by: increasing vulnerability to the security situation which affected sources of raw materials, agricultural inputs and rural markets; the scarcity of foreign exchange, which restricted access to imports of raw materials and seriously affected import-intensive industries; the existence of price and markup controls; the lack of spare parts and maintenance and the aging of equipment, most of it at least 20-30 years old; and the lack of qualified technical and managerial personnel. The fishing sector was partly affected by the security situation but even more so by the inability of the GRM to control foreign fishing vessels which severely depleted stocks in several key fishing areas.



The ERP in 1987 focused on revising the macroeconomic setting and incentive structure in order to create the right conditions for private sector led growth in a market driven economy. The extensive reforms undertaken under the program have resulted in the recovery of most economic sectors in Mozambique but the industrial sector is no larger today than it was in 1986. In fact, after a short-lived recovery during 1987-1990 (increasing an average annual 7.6 percent in real terms between 1987-1989) that was due to a large inflow of external donor funds that eased the foreign exchange constraint that was hindering the import of raw materials, output declined with serious implications for exports, contributing to a decline in the value of commodity exports from a post-reform high of $162 million in 1991 to $148 million in 1994.

Industry and fishing declined by 2.9 percent per year from 1990-1993, except for a slight improvement in 1993, as the sector continued its downward path. The major causes for this downward trend have been the increasing competition from imports, difficulties in access to credit, major structural inefficiencies and technological obsolescence. In 1990, power outages in Maputo were partly responsible for the weaker performance of industrial production. In 1992, the industrial sector was hard hit by the virtual stoppage of the major industrial units in the textile sector that followed the breakdown of trade arrangements with the former Soviet Union[6]. In general, factories had problems securing imports of spare parts and raw materials due to the lack of financing, lengthy import procedures and irregular aid reimbursements (which resulted in delays and disruptions in the supply of raw materials and other intermediate inputs) and disruptions in production occurred frequently. Despite the considerable improvement in security conditions before and after the Peace Accords, market access for finished manufactures remained constrained by damaged roads and a prevailing shortage of transport operators. In the face of great uncertainty, firms found themselves accumulating stocks of inputs in excess of normal production requirements and stocks of outputs in excess of what the market would bear. As a result, production lines were routinely suspended for extended periods and industrial capacity utilization fell well below potential.

Delays in the privatization of state-owned enterprises coupled with the progressive curtailment of subsidies led to the collapse of many firms. Two-thirds of gross industrial output remained in the hands of the state by the end of 1993 as the privatization program focused on small and medium-scale firms which have little significance in total production. The contribution to gross industrial output of those enterprises privatized before 1994 was only one percent. However, an acceleration in the privatization of large enterprises occurred in 1994 and early 1995 which bodes well for improved recovery in the industrial sector. Policy factors, namely the policies themselves, lack of policy implementation, and institutional factors have acted as constraints to industrial sector growth. The ongoing SERC and the upcoming Private Sector and Export Development Credit of the World Bank are designed to address many of the constraints that have hampered increased industrial production.

1. Structure of the Industrial Sector

[6] Agreements were negotiated in 1990 between Mozambique's textile holding company, CONTEX, and the former Soviet Union trading agency NOVOEXPORT, in the context of broader political protocols between the two governments. The terms of the agreements contemplated about $50 million in textile exports to the Soviet Union in 1991-1993 in exchange for petroleum products, military equipment and debt concessions. Russia took over the contract after the breakup of the Soviet Union but was unwilling to pay for the merchandise in hard currency rather than using debt and barter settlements, which would have required the GRM to pay the contracted amounts in domestic currency to the textile companies. The merchandise was made specifically for the Soviet market which has left the textile companies with a large inventory which they cannot move, thereby making it impossible for the textile firms to finance new production and forcing them to suspend activities.

The Mozambican industrial sector is quite diverse but output structure has remained essentially unchanged since before the independence period. Commercial fishing accounts for over 40 percent of total sector output while industrial transformation activities account for over half of total sector output. Mining (which has great potential) and electrical energy (which will change once the Cahora Bassa Dam, one of the largest in the world, reaches its full productive capacity) currently account for a only minuscule portion of total output. Food processing industries account for about a third of total gross output; light industry (such as beverages, textiles and wood processing) are also important. Unlike many other Sub-Saharan African countries, however, output from heavier industries also figure prominently in industrial production. Metallic products and machines, chemicals, and rubber and plastic products, e.g., combine to contribute over a quarter of total gross output. About 40 percent of industrial output is currently being exported (mainly agro-processing products and some non-traditional manufactures).

The majority of firms in the industrial sector are only operating at about 25 percent of capacity. Many state firms have stopped operations altogether. Often state firms continue to keep workers on the payroll (or incur wage arrears) even after production has stopped because of costly mandatory severance payment, political sensitivity to laying off workers, and uncertainty about the employment impact of privatization. Under these conditions, overhead costs have to be spread over lower output levels, further reducing factor productivity. The difficulty associated with the retention of excess labor are evident in both state-owned and private enterprises. Excess labor is estimated at 40 percent for state-owned enterprises and 25 percent for private firms. Because of high mandated severance payments, firms prefer to keep paying salaries and wait for natural attrition. This effectively makes labor a fixed cost that cannot be adjusted with production levels (which negatively affects factor productivity).

Loss-making operations of many state industrial firms have been covered partly through direct budgetary subsidies, amounting to one percent of GDP in 1993, but mostly through indirect budgetary transfers (through the banking system, subsidized inputs and inter-enterprise debts). Not surprisingly, large state industrial firms account for a high percentage of the non-performing portfolio of the banking system. Inevitably, the transfer of resources to loss-making state enterprises has crowded out access by the private sector, further constraining output recovery. In addition to the adverse business environment, most state firms are burdened by problems of poor management, low productivity, a heavy debt burden, high levels of wage arrears and the need for substantial physical rehabilitation to expand capacity utilization. The legacy of large state-run holdings continues to be evident in the concentration of sub-sector output by a few firms: 90 firms (out of a total of 500) account for 80 percent of output and employment.

On the other hand, for the most part, existing capital stock, installed technologies, management capabilities and production costs within privately-owned firms indicate that most firms would be well placed to compete in the world market given a more conducive business environment. Private sector industrial firms suffer from: a discriminatory tax collection pattern whereby a large flow of imports enters the country tax free while local producers generally have to pay taxes, severely undermining the capacity of domestic industry to compete against imports; lack of access to duty refunds or a temporary admission regime; and cumbersome and often non-transparent regulations and procedures significantly increasing the cost of doing business for the private sector (see the Business and Investment Climate section for more details).

a. Manufacturing

Manufacturing in the colonial era involved the processing of agricultural exports (tea, sugar, cotton, and cashew nuts), imported raw materials for local consumption and agricultural products for local consumption (grain milling, tobacco, soap, oil and shoe manufacturing). There were few linkages between industrial subsectors. Heavier industries included an oil refinery, engineering plants and a cement factory. The industrial base that Mozambique inherited from the colonial period was diverse and relatively large by African standards. There was significant growth in the 1960's and by 1974 Mozambique was the tenth most industrialized country in Africa. In 1973, total manufacturing value-added per capita was estimated to be the sixth largest in Sub-Saharan Africa. Initially built around agro-processing activities for exports, the manufacturing sector expanded rapidly prior to independence, reflecting an upsurge in foreign investment from South Africa. During that time, the sector diversified into manufacturing consumer and intermediate goods such as construction materials, food products, garments, furniture, glass, metal products, soap and cigarettes. By 1972, the manufacturing sector had expanded to contribute 12 percent value-added and employed 100,000 workers among 1,400 firms. Since independence, however, manufacturing has been hobbled by a shortage of imported raw materials and spare parts, a lack of skilled labor and experienced management, a statist orientation for heavy industry which was inappropriate to the country's capacity, increasingly obsolete equipment, power shortages and weak markets.

There was a marked decline in production between 1981-1986, particularly in the heavy industry sector. Industrial rehabilitation was given high priority under the ERP in 1987. At first the decline was reversed. In 1987, e.g., industrial output grew by 8.7 percent. Foreign funds helped enterprises overcome bottlenecks stemming from the inability to obtain imported raw materials and spare parts. Manufacturing output has declined since the late 1980's, particularly in textiles and clothing, pharmaceutical products and electrical equipment. The main problems are a lack of raw materials, low effective demand in the internal market, inability to compete with imported products on price or quality (partly due to the current tax and customs regime), and the drought that significantly weakened agro-industry.

There are currently a variety of projects and plans to improve the manufacturing industry, mainly by developing a better policy context for private enterprises. The Institute of Local Industry Development (IDIL) was established in the early 1990's to promote the expansion of small and medium-enterprises, which are seen as a safer basis for industrial growth than the big heavy industries favored in the past. In late 1992 the GRM formed production corridors, with special incentives to encourage businesses to set up along the transport corridors linking Mozambique's ports with neighboring countries. Investment regulations changed in 1993, allowing the Investment Promotion Center (CPI) to take advantage of increased foreign interest after the end of the war. There still remains, however, a stifling environment for the many dynamic microenterprises which could, with some encouragement in the way of credit lines and easier access to licenses, generate considerable employment and production.

i. Manufacturing Exports

As noted above, Mozambique inherited a relatively diverse industrial base, particularly in the manufacturing subsector. Mozambique has the potential to expand manufacturing exports given its diverse industrial base, cheap labor costs and high degree of underutilized capacity. Most manufacturing firms are partial and irregular exporters, with orders ranging from $10,000 - $100,000, with the exception of garment manufacturers and agro-processing firms which are 100 percent exporters. Export markets include primarily countries within the Preferential Trade Agreement (in Southern Africa), South Africa, OECD countries and the United States. The inability to access imported raw materials and intermediate inputs at world prices is one of the most important reasons for manufacturing firms lack of competitiveness in international markets. The impact of duties and customs charges on manufacturing costs can be considerable as Mozambican manufactured exports have a very high import content, averaging 65 percent for export products. The payment of duties and import charges increase the cost of imported inputs by an estimated 16-33 percent above world market prices. As a result, the manufacturing costs for these products is estimated at 10-22 percent over world prices. However, even if the payment of duties and taxes were to be avoided by smuggling the industrial inputs, the cost of smuggling is an additional cost for the exporter which would work just as an export tax.

A second major constraint is the difficulty manufacturing exporters have in getting quick access to short-term trade finance in foreign currency. This is a particularly serious constraint for most manufacturing firms in Mozambique as the current decline in output and sales led to severe shortages of working capital. Partly because of the underdeveloped status of the local banking system (see the Money and Banking section), commercial banks are reluctant to provide import finance based only on confirmed export letters of credit. In addition, quick access to foreign exchange is not always assured, given Mozambique's heavy dependence on external donor funds to finance imports, which are generally subject to lengthy administrative procedures.

ii. Agro-industrial Exports

As noted above, agro-industrial exports (cashew, tea, sugar, cotton, etc.) were a major source of foreign exchange earnings in Mozambique during the colonial period. After independence, most agro-industrial processing firms were taken over or intervened by the state and grouped into large holdings.[7] By 1980-1981, cashew, tea and sugar still accounted for a large proportion of commodity exports (40 percent). However, the adverse impact of the war compounded by the

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[7] For example, cashew factories fell under management of Caju de Mocambique and the tea estates under Emocha. The sugar estates were kept separate.

poor performance of the state-managed factories led to a steady decline in production thereafter. The war severely disrupted rural marketing/production systems and destroyed installed capacity in strategic export areas. In addition, problems of obsolete capital equipment, low productivity and high levels of indebtedness attributable to the state management of these firms, further exacerbated the situation.

With the exception of cotton which is operating and expanding under a joint venture arrangement since the early 1990's, most agro-industrial exporting firms have been partially or fully paralyzed for several years. Already starved of working capital and lacking funds to make badly needed investments to replace obsolete plant and machinery, most firms are unable to operate. Moreover, stricter lending rules and uncertainty about the future of outstanding loans and wage arrears pending privatization have made access to bank credit very difficult. Significant restructuring, through privatization/rehabilitation would be required for most firms to resume or expand production.

In the case of sugar, large investments are required to restore irrigation systems and processing capacity. At present, the rehabilitation cost of the three state-owned factories is estimated at $170 million, which if implemented could expand output to 120,000 tons per year, more than enough to cover domestic needs and the export quota. However, in order to compete with imports in the domestic market, sugar factories will need to reduce production costs, which in the past few years have exceeded even the preferential quota prices.

In the case of tea, significant replanting of the orchard base is needed as well as large-scale rehabilitations. Only two of the twenty factories run by EMOCHA, the state holding company, are operational. Another three are to be rehabilitated with multilateral funds estimated at $40 million. EMOCHA is in the early stage of privatization and it is unlikely that the company could be sold as a single unit. The possibility of subdividing the 14,000 hectare estate is being considered.

In the case of the cashew industry, privatization/rehabilitation alone will not be sufficient to ensure the economic viability of investments unless existing distortionary trade policies are corrected. Prior to independence, Mozambique was the largest world producer of cashew with a production of over 200,000 tons and a capacity to process 150,000 tons of raw nuts per year. Current production is only about 35,000 tons per year versus an output potential of 80,000 tons and processing capacity of 40,000 tons per year. Depressed output levels reflect the impact of the war, aging orchards and unfavorable prices for raw nuts enforced to support an inefficient industry.

The cashew processing industry is inefficient due to the use of mechanized capital-intensive methods which are not competitive with major world producers like India and Brazil as well as the poor performance of state-run factories which are geographically not well located. In fact, cashew factories in Mozambique have been generating marginal or negative value added. The technical performance of cashew factories in Mozambique is extremely poor. This implies that the country could actually earn more foreign exchange by exporting raw nuts instead of kernels. To protect this inefficient industry, the farmgate price of raw nuts has been kept down both through low minimum prices and export restrictions on raw nuts. Lack of competition within the cashew market has meant that minimum prices effectively operate as fixed prices. The minimum farmgate price has average less than 20 percent of the border price over the past years, which is extremely low by international standards (e.g., in Tanzania the share is 50 percent of FOB and even this is considered to be highly inadequate). In 1993, only one private factory with a capacity of 6,000 tons was operating. Therefore, the GRM only allowed the export of surplus raw cashew output (about 22,000 tons). Export licenses were issued to six wholesale traders, who dominate the cashew market in Mozambique. As a result, these six traders and one factory made profits equivalent to four times the combined income of several hundred thousand farmers producing raw cashew nuts. Policies are clearly reducing incentives and incomes for cashew farmers, encouraging the rehabilitation of inefficient capital-intensive processing factories, and compromising export growth for the country as a whole. A shift toward semi-manual or manual techniques will probably be required if Mozambique's cashew processing is ever able to maximize foreign exchange earnings and farmers' incomes. During the end of 1994 and beginning of 1995, several policy measures were implemented which should help improve the incentive environment for cashew production and processing.

b. Fishing

Coastal and deep-sea resources were never exploited on a large scale in the colonial period but the sustainable catch is estimated at 500,000 tons of fish and 14,000 tons of prawns. Since independence, prawns and shrimps have become major exports. Mozambique's own fishing fleet is limited but Japan, Spain, Portugal and South Africa are all present through either joint ventures or direct licensing schemes. The European Union has an agreement with Mozambique to catch 20,000 tons of fish and shellfish per year in return for a grant of $35.2 million for research and development. Japan has granted Mozambique $5 million to investigate unexploited areas in the 200 nautical mile zone off the Mozambican coast.

The total annual fish catch has show a significant overall improvement since independence (the 1986 catch was double that of 1975). Much of this was the result of higher landings of species other than prawns but figures indicate that the 1988 shellfish catch was higher than that of 1975 (although lower than the best year in 1981). Yields generally declined from 1975-1979 and then began to recover, reaching a record level of 8,700 tons in 1981. Shellfish yields then declined before embarking on a steady growth path from 1986 onwards. A temporary ban on shrimp fishing in late 1990 and early 1991 and a ceiling on the 1991 catch were imposed to combat overexploitation. In 1992 the shellfish industry was temporarily hit by the effects early in the year of the Katina P oil spill off the southern Mozambican coast. With much of the traditional agricultural export sector depressed by the effects of the war, the fisheries sector has emerged as Mozambique's principal merchandise export category. New markets have developed and old ones reemerged, including an eager market for sea cucumbers in Hong Kong.

The State Secretariat of Fisheries presented its Master Plan at a conference in October 1994. The Plan responds to an urgent need for a strategy in the sector which emphasizes the role of the private sector. It also emphasizes the importance of the sector, which contributed 54 percent to total exports in 1993. It is expected that the Master Plan will have a significant effect on Mozambique's balance of payments, increasing the positive net amount from $40 million in 1993 to $84 million in 2005. An increase in employment of 40 percent (mainly artisanal) is anticipated over this period with significant participation of women in processing activities. The Plan envisions upgrading the currently non-viable industrial fleet and would promote pelagic fisheries outside the Sofala Bank and establish new fishing harbors. Attention will also be given to artisanal fisheries to improve production and reduce post-harvest losses.

c. Mining

Mineral exports have not so far earned significant sums of foreign exchange. In 1993, mineral exports accounted for only 3 percent of total exports. Production, which has considerable potential and has been generating interest among prospective investors, has been hindered by insecurity, obsolete equipment and transport problems. The most significant minerals are the pegmatite deposits in Zambezia province, which are now being mined for columbotantalite, beryl, mica, bismuth and semi-precious stones. Mozambique probably has the world's largest reserve of tantalite which is used in the electronics industry and for special steels. The large potential of tantalite may eventually make it Mozambique's most important mineral export. Tantalite mining at Murrua, originally supported by the former East Germany and Soviet Union, had to be abandoned during the war for security reasons. However, Russian and South African mining houses have been reexamining the deposits. An internationally competitive tax regime for the petroleum and mining sectors came into effect in 1993.

Sea salt production has increased steadily since independence and the output is now exported to neighboring countries. Small quantities of copper (with traces of gold), marble (Cabo Delgado province), garnet (Niassa province), kaolin (Nampula province), asbestos (Manica province) and bentonite (Maputo province) are also mined. Limestone is quarried for cement production. In April 1986 Lonrho negotiated an agreement to mine gold in Manica province near the Zimbabwean border, on a seam which the British company already mines in Zimbabwe. Official estimates of reserves are low but one South African company estimates that the area may hold one of the largest gold deposits in the world. Officially recorded production of gold has declined, although earnings have risen because of price increases. However, there is a large amount of gold smuggling, much of it allegedly routed through Tanzania. A U.S. firm, Edblow Resources, was given a 27 year concession in 1986 to explore and exploit titanium-bearing beach sand along 200 kilometers of coastline in Zambezia province. Another mineral sands project has been set up to exploit a deposit along the coast of Zambezia province which could yield up to $44 million per year in revenue. Graphite mining in the north is expanding. Kenmare Resources, an Irish company, is mining industrial grade graphite at Ancuabe and the European Investment Bank has agreed to a loan to a joint venture planning to produce 7,000 tons per year. There are also deposits of graphite in Tete and Nampula provinces. Apart from these minerals, the country's principal prospects are 100 million tons of high-quality iron ore in Tete province, which is intended eventually to be the basis for local iron and steel production using coal and electricity available locally. Large nepheline syenite reserves nearby could be used to produce aluminum. There are also deposits of bauxite in Maputo province (estimated at 4 million tons), apatite (Nampula province), and tin (Manica province).

d. Energy

Mozambique has the potential to be a net energy exporter, selling hydro-electricity and coal. Exports of both electricity and petroleum products were virtually halted by the war. As the table shows, current energy production is not even sufficient to satisfy domestic demand - both coal and electricity have to be imported.

A new domestic energy program was established in mid-1989 with the objective of reducing the negative environmental impact of the increasing use of wood for fuel by promoting alternative forms of energy. About 400,000 tons of timber were being consumed annually and, although various reforestation projects aimed at planting 1,500 hectares per year, there still would have been a net depletion. The program envisaged spending $25 million on promoting the use of gas, paraffin and coal for domestic use.

Primary Energy Balance, 1993
(million tons of oil equivalent)

	Oil	Gas	Coal	Electricity	Other	Total
Production	0.00	0.00	0.03	0.09 /a	3.52	3.64
Import	0.45	0.00	0.01	0.14 /a	0.00	0.60
Exports	0.00	0.00	0.00	0.00	0.00	0.00
Primary Supply	0.45	0.00	0.04	0.23 /a	3.52	4.24
Net Transformation /b	0.06	0.00	0.02	0.17	0.00	0.25
Final Consumption	0.39	0.00	0.02	0.06 /c	3.52	3.99

/a Expressed as input equivalents on an assumed generating efficiency of 33 percent.

/b Transformation input and output, plus energy industry fuel and losses.
/c Output basis.
Source: Energy Data Associates (Economist Intelligence Unit).

i. Oil and Gas

The existence of large natural gas reserves in the Pande field in Inhambane province was known before independence. A survey by a British company estimated reserves at about 40 billion cubic meters. Early in 1992 the parastatal Empresa Nacional de Hidrocarbonetos (ENH) signed an agreement with South Africa's SASOL company to exploit the gas and export it through a 900 kilometer pipeline to the South African province of Transvaal. An original plan to pipe gas from Pande to South Africa was interrupted by Mozambican independence and the worsening political relations between Maputo and Pretoria. Renamo activity also hindered exploration and exploitation of the field, which many industry analysts believe has far greater reserves than that indicated by the British survey. An American firm, Enron, is in the process of completing an agreement with ENH to build the pipeline which it is estimated will provide Mozambique with $50 million of foreign exchange annually.

Post-independence seismic surveys show that Mozambique has greater oil potential than expected, although still small by world standards. The most promising zones are the Rovuma basin in the north on the border with Tanzania, the Zambezi basin and off the coast of Gaza province. Between 1985 and September 1990 the foreign investment office approved oil and natural gas prospecting projects worth $20 million. During 1994 some 20 companies were bidding for oil exploration permits in the Limpopo, Zambezi and Rovuma basins.

Mozambique currently imports all of its fuel refined. A refinery was built in 1961 at Maputo but it has not operated for several years but is now obsolete. Until 1990, 75 percent of Mozambique's fuel was provided by the Soviet Union. With the breakup of the Soviet Union, Mozambique now has to pay for all of its oil at commercial prices. Petromoc, the large petroleum parastatal, was the sole importer and controlled 80 percent of distribution until 1990. It is currently in the process of being restructured and privatized. .

ii. Coal

Tete province has known coal reserves of over 6 billion tons. The largest is Mucanha-Vuzi with 5 billion tons, half coking coal and half steam coal. Currently only the Moatize reserves are being exploited but production at two underground mines has in recent years been at levels less than 10 percent of design capacity. The main cause of very low coal output has been the war, which not only rendered mining insecure but also made transporting the coal to the ports extremely hazardous and costly. Although production rose after independence, output and exports have plummeted since the early 1980's. Production is possible but the chief constraint continues to be the cost of transporting the Moatize coal to port, which will require an investment in infrastructure of about $1.5 billion.

Moatize and other northern coal fields have considerable potential. One pre-feasibility study has claimed that Moatize could produce 9 million tons of saleable coal annually. In anticipation of improved security, the Ministry of Mineral Resources and Energy, along with the Brazilian Companhia Vale do Rio Doce, the UK's Lonrho and Trans Natal Coal, have undertaken preparatory studies as a basis for expanding existing operations.

iii. Electricity

Mozambique's natural resource endowment should provide the country with extremely cheap electricity and a substantial surplus for export. Civil war and mismanagement, however, have resulted in exports of electricity far short of capacity and very expensive domestic electricity. The huge Cahora Bassa dam on the Zambezi river, completed in 1974, was built by Portugal to supply electricity to South Africa. Portugal agreed to sell electricity at prices so low that the dam could never make a profit. At independence Frelimo refused to take responsibility for this "great white elephant". As a result, the Portuguese firm HCB runs the dam while Portugal remains responsible for paying off debts incurred in its construction. Mozambique now owns about 15 percent of HCB and will steadily receive a larger share until it owns the whole project in the year 2014. Cahora Bassa is linked to the Apollo substation between Johannesburg and Pretoria by a 1,400 kilometer (860 kilometers in Mozambique) 533 kilovolt direct current line, one of the longest in the world. Cahora Bassa has a 2,075 megawatt power station which should provide South Africa with 1,883 megawatts and leave about 150 megawatts for Mozambique.

After the signing of the Nkomati Accord with South Africa in 1984 there were tripartite talks between South Africa, Mozambique and Portugal which resulted in an agreement to increase payments to Portugal, make payments for the first time to Mozambique, provide more electricity to Mozambique and take joint action to protect power lines. However, Renamo sabotage continued and Mozambique derived little benefit from the agreement. By the end of the war, more than 1,500 of the 4,000 pylons had been destroyed by Renamo. The hydroelectric installations at the dam itself were, however, maintained in a good state of repair. Preparatory work on the line began in 1992 after the South African power utility, ESKOM, mediated an understanding with Renamo whereby rebels would cease attacks on the line. ESKOM has considerable interest in the scheme, as part of a plan for a regional power grid. A rehabilitation scheme for Cahora Bassa was negotiated in 1994 between Mozambique, South Africa, Portugal and other countries.

Other projects also use Cahora Bassa power. In 1980 Tete City and Moatize coal mine were linked to the power station and in 1984 a 1,000 kilometer line to link Quelimane, Mocuba and Nampula was completed. A line was built by East Germany from Nampula to Nacala in 1983. An agreement signed in April 1992 provides for electricity exports from Cahora Bassa to substations near Harare which could raise capacity utilization at the dam to about 20 percent. Once the Cahora Bassa projects are fully implemented, the average cost of power generation should fall and the marginal cost of electricity in the major centers will make it the lowest cost fuel for many consumers.

A third independent system is in the south where Maputo is linked to South Africa by a 275 kilovolt line. The capital's backup supply comes from a 60 megawatt coal-fired power station in Maputo, which also has a reserve 52 megawatt gas turbine generator. These facilities were upgraded in 1985 following frequent incidents of sabotage of the line from South Africa.

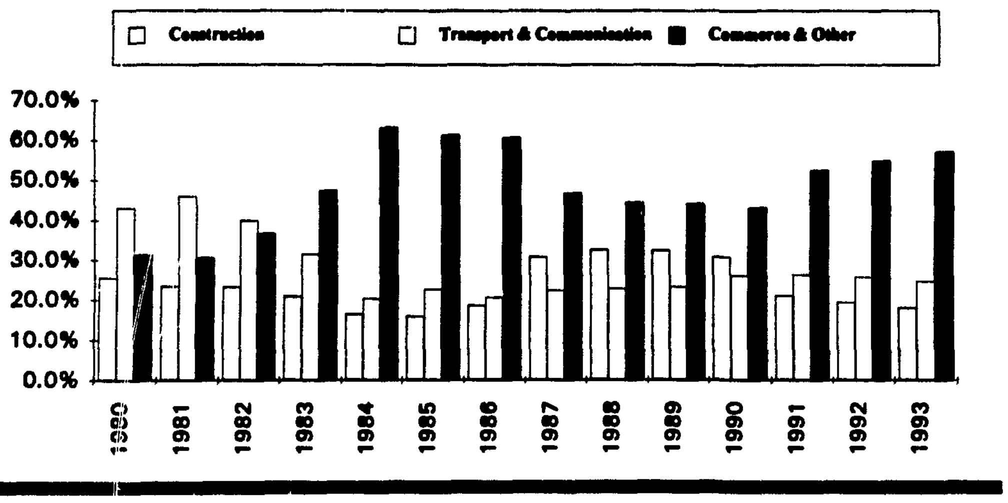
An innovative pilot metering program is being installed in part of Maputo which should help to minimize the difficulties customers have in budgeting for electricity use. A separate pilot program is being developed for bringing electricity to district capitals outside of the national electricity parastatal (EDM) system, starting with two cities close to the Pande Gas field and two others in the north. This program may also involve private electricity operations. EDM has been making significant strides towards establishing itself as a public company. It has received GRM approval of a medium-term strategy which should restore its financial health and lead to a sustainable position (it has substantial outstanding debts from other public sector enterprises).

E. Services and Other

1. Structure of the Services Sector

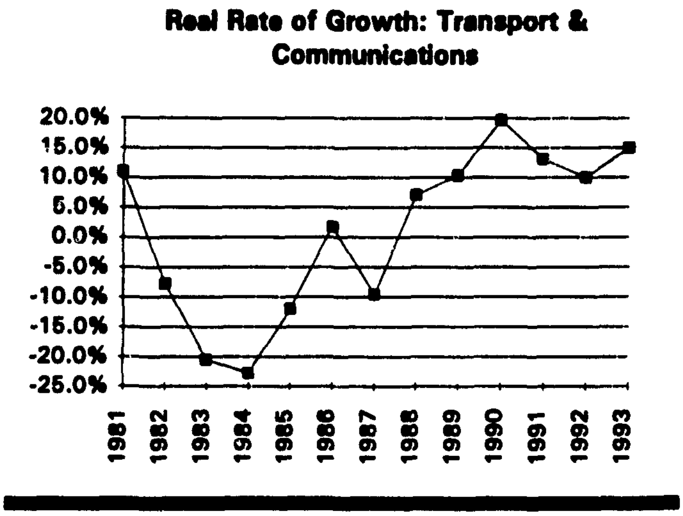
Overall, the services sector, with the exception of construction, declined during most of the 1980's. During the late 1980's and early 1990's, all sectors increased at real positive rates of growth. Commerce and other services are the major component of the services sector while construction and transport have retained secondary roles.

Structure of the Services Sector



2. Transport and Communications

Mozambique's ports and railways, through the government parastatal (CFM), were developed to serve neighboring countries. These are now potentially the most important ports for several of Mozambique's partners. However, insecurity and sabotage on the lines have limited access to Mozambique's ports until recently. Sabotage of the transport infrastructure was probably the most crippling cause of the decline but poor management has exacerbated the problem and the GRM faces a considerable challenge to attract traffic back to the Mozambican transport network.



Mozambique's transport sector deteriorated significantly during the 1980's (a continuation of the trend from the 1970's). Activity declined dramatically for all transport modes except aviation (which has declined in the last two years). The present poor condition of the transport infrastructure is attributable to many factors, including: the destruction caused by the war and associated security problem; the shortage of managerial and skilled manpower; the diminished resources available for investment in infrastructure as a result of economic deterioration; the neglected maintenance due to unavailable financing and lack of proper organization of maintenance activities; and inappropriate transport sector policies. In addition, investment in the transport sector has traditionally been biased towards the major port-rail transit corridors serving Mozambique's inland neighbors, although there has been little internal demand. This has led to relative neglect of the transport infrastructure to serve the needs of the Mozambican domestic and export economy.

Transport activity in Mozambique in 1990 was characterized by tariff increases for both freight and passenger travel, a marked decline in freight activity and air travel and a substantial expansion in rail and road travel. Activities with higher tariff increases experienced the most significant declines in real growth. The structure of total receipts shows a tendency toward an increase in the share of freight (from 46 percent to 49 percent between 1988-1990) and a decline in the share of passenger receipts (from 39 percent to 33 percent between 1988-1990). The structure of freight receipts illustrates the continued importance of port activity and air freight. Passenger receipts were dominated by air travel (84-88 percent in 1989-90), which was the predominant means of interurban transportation in view of rural security conditions. Air travel receipts incorporated high cross-subsidization of domestic fares by international fares.

Transport activity in Mozambique was buoyant in 1992, extending the remarkable growth the sector experienced since 1988. Transport operators, particularly the railways company, greatly benefitted from the transportation needs arising from the drought-related provision of external aid. They also benefitted from the cessation of armed hostilities in October 1992 which allowed access to areas that had previously been isolated. Regional roads and railway lines to Swaziland and South Africa were reactivated in early 1993. Railroad freight volumes per kilometer of track more than doubled in 1992 from 1991 as a result of the handling of drought-relief assistance by CFM, the state railway authority, for Mozambique and neighboring countries. Railway passenger traffic, however, fell by 57 percent, owing to sharp tariff increases and to more people venturing by road. The latter reflected positively on road traffic, which increased by about 25 percent, partly fueled by the drought relief operations. Most of the growth in road traffic since that time has been generated by private sector operators that are gradually expanding urban and intercity bus connections. Air traffic fell in 1992 for the second year in a row, as a result of airfare increases and LAM's downsizing efforts, which included the elimination of two former routes to Europe. Maritime traffic fell by 16 percent in 1992, reflecting the diminished need for transcoastal shipping after surface communications were restored and also the aging and lack of maintenance of Mozambique's fleet that forced vessels out of circulation. Port handling increased in 1992 by 17 percent, largely because of drought-related merchandise inflows.

In contrast to previous years, in 1991-92 sharp increases in transport tariffs were made with a view to setting prices closer to cost recovery. In the case of urban bus fares, prices rose by 77 percent during 1992, despite increased competition from private operators. Railroad fares were increased by 150-200 percent.. Domestic airfares, which had long been cross-subsidized by international fares, were also increased significantly (and more frequently) to reflect the depreciation of the metical and, when warranted, higher fuel costs. With the exception of road passenger traffic, which surged from extremely low levels, all other forms of passenger traffic appear to be price elastic.

Notwithstanding the improvements made during 1992, the two largest public enterprises in the transportation sector (CFM and LAM), continue to face financial difficulties. CFM, however, has received about $1 billion over the last 10 years and its primary constraint is management problems. The widespread destruction of tracks and bridges and the aging of CFM's equipment render unlikely any prospects of operating at a profit in the near future, despite massive efforts by donors to rehabilitate Mozambique's railroad corridors. LAM, on the other hand, was hurt by the global crisis in the airline industry, the closing of two routes to Europe, and more importantly, by the stepped up devaluation of the metical since 1991. The pullback from the two European destinations followed the return of Mozambican emigrants in the former East Germany who had long provided a steady, profitable source of demand for LAM. The price rises generated little additional revenues as traffic losses continued.

The transport and communications sector has continued to grow (albeit from a relatively low base), fueled in large part by the handling and distribution requirements of food relief aid donated in response to the drought. As security is restored throughout the country and damaged infrastructure is repaired, passengers and merchandise are beginning to circulate in larger numbers.

The communications sector is also steadily improving and major investments have been made. Communications improved steadily with major investments made to upgrade existing networks and the state telecommunications corporation remained relatively profitable. Activity in the communications sector picked up considerably in 1993 with the establishment of new satellite linkages.

a. Ports

There are three major ports: Maputo, Beira and Nacala. All three ports have facilities for container and palletized traffic, which are being upgraded or have plans to be upgraded. There are SADC-backed projects under way in all three ports port. Because of the aged Mozambican fleet and relative inefficiencies, intra-coastal shipping remains cost-prohibitive.

Maputo port is one of the largest ports in Africa. It has a 3.3 kilometer long main wharf with specialized steel, bulk sugar and molasses handling facilities and a citrus cold store. The adjoining port of Matola has bulk ore and fuel terminals. It handled mainly Swazi iron ore (until the Swazi mine closed down in 1980) and South African and Zimbabwean chrome. South Africa steadily reduced traffic through Maputo, cutting it to less than 10 percent of the 1973 level by 1988. With improving diplomatic relations between the two countries, progress in repairing key railway lines and brightening peace hopes, South Africa businesses are showing renewed interest in the Maputo port. In 1990, Maputo port handled 2.95 million tons of cargo, compared with a projected throughput of 3.1 million tons. In mid-1991, port activity declined even further as Swaziland shifted its route of all of its sugar to Durban because of the high pilferage rate in Maputo (which also occurred on the rail line). A new container terminal has been built and South Africa has loaned Rand 9.2 million for refurbishing the bulk coal terminal in Maputo port, providing management assistance for two out of the port's six specialized handling facilities as well as the general cargo berth. Despite continued problems with pilferage, the management and performance of the port was improving rapidly in 1992-1994. The sugar and citrus terminals have been leased to private companies.

Beira port has a 1.7 kilometer general cargo wharf, a citrus cold store, molasses and tallow tanks, coal handling facilities and a major fuel terminal for Malawi and Zimbabwe. A ten year plan by SADC was announced in January 1986, worth $600 million, to rehabilitate Beira port and improve transport links to Zimbabwe, Malawi and Zambia. The Beira Corridor program, which was given top priority, covers the port, roads, railway lines and town projects. New installations for the port were inaugurated and rehabilitation of the railway line linking the port to Zimbabwe was completed in 1987. The railway is now able to take all the traffic the port can handle and traffic has increased since 1990. The first phase of the modernization of the port of Beira was completed in April 1992 with the formal commissioning of the new $100 million container handling terminal, the largest single project in the Beira Corridor program. The port's capacity is now 7.5 million tons per year. The dredging of the access channel from 6 meters to 8.5 meters was completed in mid-1990, allowing vessels of up to 50,000 tons to enter the port. The port handled 1.7 million tons of cargo in 1991 (including fuels) and increased handling to 2.4 million tons in 1992 as the port successfully handled food aid for the drought in the region.

Nacala port is the best deep water port in East Africa with a 1 kilometer berth. A 6.2 hectare container terminal at Nacala port is now operating with Finnish technical and managerial assistance.

Cargo through the Port of Beira
(1000 tons)

	Exports		Imports		Total	
	1991	1992	1991	1992	1991	1992
Dry Cargo	249.0	228.2	298.7	1086.8	720.0	1396.3
Botswana	0.0	0.0	6.4	0.4	6.4	0.4
Malawi	21.5	10.9	5.5	84.4	27.0	95.3
Mozambique	41.9	19.0	158.3	285.3	327.5	385.6
Zaire	0.0	0.0	0.0	37.4	0.0	37.4
Zambia	30.8	29.1	18.2	88.2	49.0	117.3
Zimbabwe	199.8	169.2	110.0	591.1	310.1	760.3
Fuels	0.0	0.0	983.9	1011.9	983.9	1011.9
Mozambique	0.0	0.0	79.4	66.6	79.4	66.6
Zimbabwe	0.0	0.0	904.5	945.3	904.5	945.3
Total	249.0	228.2	1282.6	2098.7	1703.9	2408.2

b. Railways

Emergency rehabilitation on the rail line between Zimbabwe and the port of Beira was completed in 1987. Work on the Limpopo line linking Zimbabwe directly to the port of Maputo was completed in early 1993. The first phase of the Nacala project, involving the renovation of the line between Nacala and Nampula City, was completed in 1987. Work on the second phase (Nampula-Cuamba) was delayed because of the war but was resumed in late 1990. A major part of the Nacala line was reopened in late 1993. There are 88 kilometers on the Nacala line that need rehabilitation near the border of Malawi. The Nacala line only becomes viable if coal from Moatize is carried through the Nacala port at a rate of 10 million tons per year. The rehabilitation of the Maputo-Swaziland route is completed.

During the later years of the civil war, the Beira Corridor railway was kept open with the aid of Zimbabwean troops, while special battalions trained by France and the U.K. helped secure the Nacala line and the Limpopo line, respectively. The Southern African drought in 1992 spurred a successful operation to transfer grain relief to Zimbabwe via the Limpopo railway, raising traffic volumes on the line significantly. Institutional rehabilitation has begun with the restructuring of the ports and railways authority.

c. Roads

New construction and maintenance of roads came to a halt in 1982-1983. The national network of public roads is managed by the National Directorate of Roads and Bridges (DNEP) and comprises 5,300 km of paved roads and 23,900 km of earth/gravel roads. Although only limited data exists on the status of the network, it is estimated that less than 10 percent of the network is now in good condition and more than one-third is currently not transitable on a regular basis. The feeder roads (low-volume secondary and tertiary roads) are in poor condition and many are currently impassable. Together this constitutes a major constraint to the transport of farm produce to the points of consumption and export. Consequently, road user operating costs are high and vehicular traffic is currently very low and sporadic on much of the network. A major rehabilitation effort of the road system is under way through the World Bank's ROCS II program (in which USAID is participating).

Since the end of the war, increasing traffic has overburdened some of the main routes, including the link between Maputo and Swaziland and the main road linking the south and north of the country. Many rural roads are still dangerous because of mines. There are several demining projects currently in place.

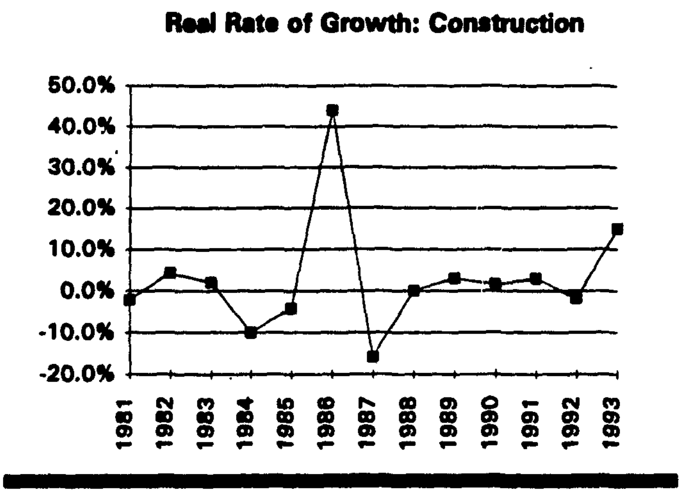
d. Air Transport

The state airline, Linhas Aereas de Mocambique (LAM), took delivery of one new Boeing 767 and two smaller Boeings in 1992 to replace its DC 10 on intercontinental routes. The airline links Maputo to six of the nine other provincial capitals. International flights have dropped dramatically and are now limited to Dar es Salaam, Harare, Johannesburg, and Lisbon, A second state company, Empresa Nacional de Transporte e Trabalho Aereo (TTA) provides scheduled and chartered light plane and helicopter services. Light plane services are also operated by non-Mozambican feeder airlines to Nelspruitt and Durban in South Africa and to Manzini in Swaziland. TTA is currently in the process of being privatized.

LAM embarked on a restructuring program in 1992 to develop its services and restore financial order. Domestic air fares on LAM were increased by almost 100 percent in a bid to reverse the domestic losses recorded every year since 1987. Plans were announced in 1993 to prepare LAM for privatization, although to date the process has been slow and interest is minuscule. LAM's financial difficulties, in spite of budgetary support, have increased significantly.

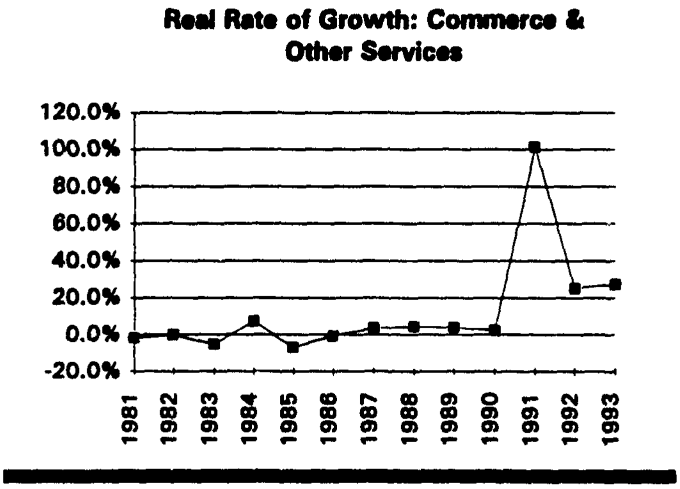
2. Construction

Although construction had sharply recovered in 1986 from previous sharp cutbacks in investment, this sector remained heavily dependent on public works contracts and was affected by the insecurity related to the war. Construction output increased 4.4 percent, on average, during 1990-1993 as the sector began to recover, primarily benefitting from such projects as the rehabilitation of the three railway corridois and respective harbors. The National Reconstruction Program (PRN) envisions a major role for domestic and foreign construction firms in the rehabilitation of damaged infrastructure. Construction is expected to increase dramatically in 1994 in response to a large increase in private sector construction activity.



3. Commerce and Other Services

Commerce and other services have expanded by about 3 percent a year since 1989, reflecting the liberalization of the economy and its increasing openness. Data on output of commerce and other services are based on information that covers about 70 percent of the sector. It is expanding mainly because of steady demand in large urban areas. As access to provincial markets improves, there should be continuous growth. Commerce and other services surged by 39 in percent between 1990-1993 (with a particularly sharp increase in 1991 of 191 percent) as the economy opened up, expanding because of a steady demand from large urban areas as liberalization of the economy proceeded. Commerce and other services are comprised of: other services (broadly defined); commerce; and restaurants and hotels.



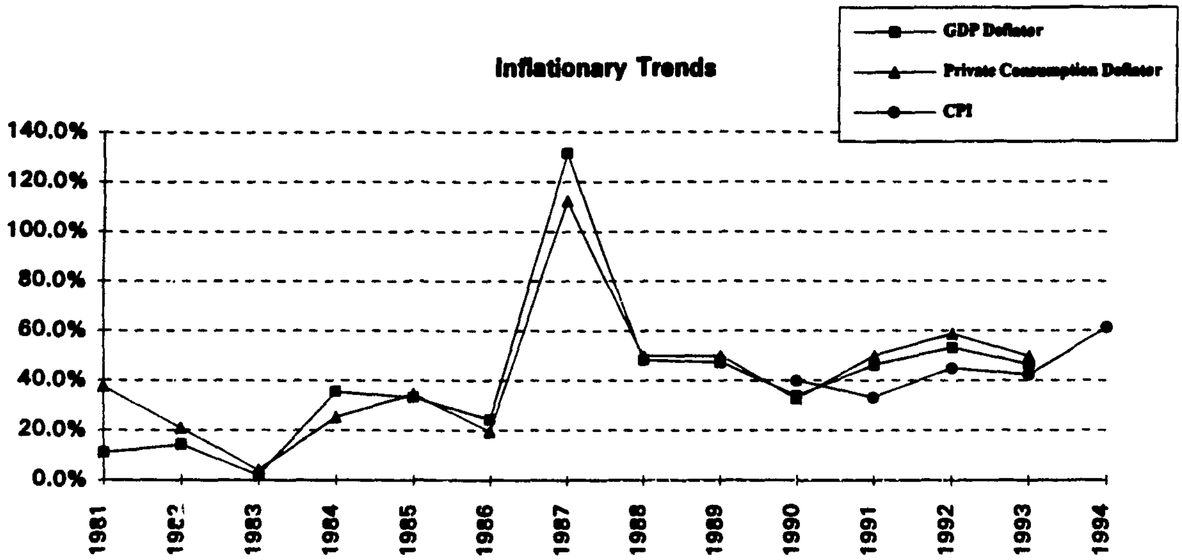
a. Tourism

The tourism infrastructure was worn down after independence by war and Frelimo's initial discouragement of tourism. After Zimbabwean independence in 1980 tours resumed from this important market. After the passage of a new foreign investment law in 1984, the sector's fortunes slowly improved. Several hotels were rehabilitated and a number of dilapidated hotels around the country have been the subject of interest, proposals, or concrete investment, mainly from Portuguese and South African companies. The GRM hopes to draw up a strategic development plan to develop tourism. The importance of tourism as a foreign exchange earner and employer, with significant linkage effects, is increasingly recognized. Figures are still very difficult to obtain but some observers suggest Mozambique could earn about $80 million from tourism per year within three years (which is the equivalent of two-thirds of the level of merchandise exports in 1993).

Prices, Wages and Employment

I. Inflationary Trends

Mozambique has faced and continues to face strong inflation, although its precise measure is open to discussion, given the shortcomings of the Consumer Price Index (CPI) and differences among various price indicators. The historical experience is illustrated below, with a comparison of the GDP deflator, private consumption deflator and the CPI from 1989[1].

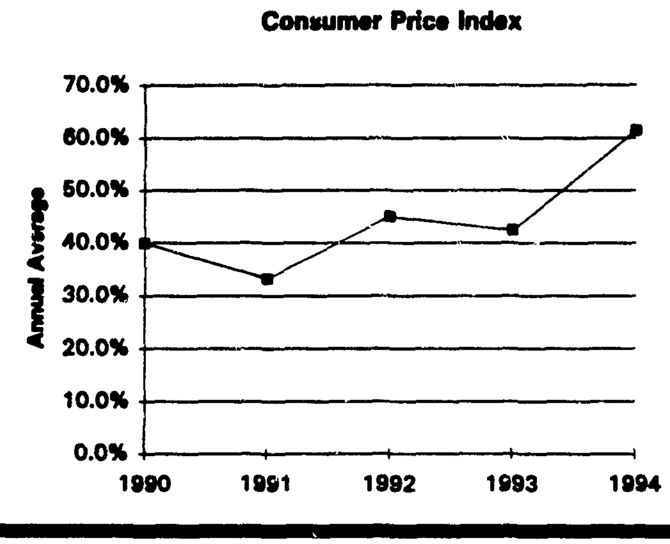


Because of the highly controlled economic structure after independence and during the early to mid-1980's, it is difficult to ascertain prices in real terms, given the resulting repressed nature of inflation. The GDP deflator has been lower than the private consumption deflator at various times, reflecting terms of trade losses, which were particularly significant during 1980-1983. On the other hand, the impact of the major devaluations, e.g., 1987-1988, on domestic prices was muted by the fact that prices of most commercially imported goods were based on the parallel exchange rate rather than the official rate. Following a sharp price deceleration in 1988,

[1] Mozambique's current CPI was introduced in December 1989 as a first attempt to estimate inflation based on a rough survey of family expenditure in the Maputo area. The prices of 1,060 products in 250 licensed shops (at official prices) and in the parallel market (parallel prices) were monitored. Weights used are those from an August 1984 expenditure survey of randomly selected households. The CPI covers only goods and services offered in Maputo and is highly dependent on the prices of a few food staples that are subject to strong seasonality, especially tomatoes and cabbage, which together account for 10 percent of the CPI. As a result, the CPI occasionally deviates from other price indicators, namely the deflators of private consumption and GDP. Efforts are currently underway to re-weight the index and broaden its geographical coverage.

disinflation did not proceed as fast in 1989 and 1990, because of excess demand, domestic supply shortages and shortfalls in food aid deliveries. Strong monetary and credit expansion as well as continuous pressure on the exchange rate (as evidenced by the persistent gap between the official and parallel exchange rates) continued in 1989 and 1990, suggesting that excess demand conditions persisted. On the supply side, domestic food production continued to be insufficient as farming in general and access to rural areas was frequently disrupted by the war. In addition, Mozambique continued to suffer from poor agricultural marketing structures and disruptions in road and railway transportation systems. In early 1990, frequent power outages in Maputo reduced domestic production in manufactures. Apart from the price increases in late 1990, other cost-push elements (including wage adjustments and exchange rate devaluations), do not appear to have been the primary factors of inflation during this period.

Mozambique continued to record high rates of inflation. Average annual inflation, as measured by the GDP deflator, fell from 131.5 percent in 1987 to 33.9 percent in 1990 but accelerated to 53.2 percent in 1992. The monthly CPI, first initiated in December 1989, recorded strong inflation in 1990 (an annual average of 40 percent), primarily as a result of increases in the prices of cereal grains (44.7 percent increase); increases in the prices of meat, fish, milk and eggs category (89 percent increase), contributing over 22 percentage points to inflation; increases in the price of charcoal (the demand for charcoal increased significantly as power outages became more frequent) which led to an increase in the energy category of 99 percent; and a rise in urban transport prices[2] which led to an increase of 149 percent in the services category. In addition, there was a general wage increase in January of 16 percent and adjustments in administered prices in February, following the initial upsurge that occurred during the first quarter and adding to its effects.



In 1991, the rate of inflation declined to an average annual 33.3 percent increase. The prices of industrial products increased by 67 percent, contributing 20.8 percentage points to inflation. The prices of cereal grains increased 50 percent and the prices of fresh produce increased 36 percent (after an increase of only 9.1 percent in 1990).

[2] A major component of this item was informal urban transport, often in open trucks. The business was unregulated until January 1990. Rates remained unchanged for years (at MT 100 per trip, irrespective of the distance). In January 1990, the GRM decided to regulate this activity for 'safety reasons'. The supply was reduced and prices doubled in February.

In 1992, the year of the drought, the average annual rate of inflation reached 45 percent. The acceleration in inflation was mostly a reflection of the rise in the prices of fresh produce, which increased by 153 percent and contributed 30.3 percentage points to inflation. The prices of two major cooking vegetables alone, which account for roughly 10 percent of the CPI, increased by 362 percent (tomatoes) and 134 percent (cabbage). Prices in the services category increased by 84 percent on account of the almost doubling of urban bus tariffs. The impact of the drought on the prices of cereals was not as strong, because they were supplied in sufficient quantities through external aid. However, sharp increases in prices for maize and wheat flour caused the cereals group in the CPI to rise by 38 percent. On a 12 month basis, inflation, as measured by the CPI, reached 54.5 percent in December 1992, of which an estimated 20-25 percentage points were directly attributable to the drought's impact on food prices.

In addition to the drought, there were other structural and policy causes for the price acceleration during 1992. On the supply side, domestic food production continued to be insufficient as farming in general, and access to rural areas, were considerably disrupted by periodic natural disasters and the war before the October Peace Accords. On the policy side, excessive monetary and credit expansion continued to place pressure both on exchange rates and prices in 1991 and 1992. Wage adjustments do not appear to have been a major factor in the acceleration of inflation because they tended to lag behind inflation and purchasing power was considerably curtailed since 1989 (see the Wage section below).

The rate of inflation declined slightly to 42.3 percent on an average annual basis in 1993. Despite an encouraging price performance in the first half of 1993 (when prices increased by 16 percent as compared with 30 percent in the same period of the previous year) as the inflation rate responded to the tightening of economic policies, the December 1993 inflation rate of 43.6 percent exceeded the 30 percent program target. Large corrections in energy prices, particularly diesel, led to an overall increase in the energy category of 100 percent. Prices of meat, fish, milk and eggs increased by 69 percent, contributing 17.4 percentage points to inflation and price increases in industrial products increased by 52 percent, contributing 16 percentage points to inflation..

There was a significant acceleration of monetary expansion during the second half of 1993 (particularly the last four months). Mozambique faced a significant shortfall in the generation of counterpart funds (roughly 11 percent of GDP), resulting from lower than expected disbursements of foreign aid. Despite a better than expected performance in the recuperation of counterpart funds and a lower underlying budget deficit, before grants, than programmed, the GRM had to borrow MT 51 billion from the banking system, instead of repaying MT 64 billion as programmed. Total revenues declined by one percentage point of GDP as the strong growth of the agricultural sector did not result in a pari passu increase in tax and nontax revenues. While there were expenditure overruns in some categories reflecting a larger than expected devaluation of the metical and pressures resulting from the negotiations to implement the peace accords, the overall budget deficit before grants was lower than programmed. However, these results were in part obtained because delays in the implementation of the peace process forced the postponement of special expenditures associated with demobilization and elections to 1994 (expenditures with respect to special factors were less than 12 percent of the level programmed for 1993).

As noted above, monetary aggregates increased rapidly in the second half of 1993. After valuation adjustments, the increase in the money supply during 1993 was 61 percent, significantly in excess of the program target of 21 percent. The main reason behind this development was a rapid growth in net domestic assets (116 percent and 70 percent in terms of beginning-period broad money as compared with a target of 13 percent) which reflected, in part, the expansion of net credit to the GRM, but more importantly, also reflected a number of expansionary factors within other items net. These factors included an implicit credit expansion to importers resulting from delays in charging them for imports made with letters of credit and foreign exchange losses by BM, which resulted from BM using a lower exchange rate to charge importers than the exchange rate it used to credit the GRM for counterpart funds (this procedure was discontinued in January 1994). In addition, the increase in other items net (OIN) resulted from a continuous expansion in the unidentified assets and liabilities component, which is primarily made up of non-performing loans of state enterprises.

The metical depreciated by 81 percent against the U.S. dollar during 1993. The rapid decline of the metical against the dollar was a result of four factors: 1) the above-mentioned rapid expansion in the money supply in the second half of the year; 2) the reunification of the exchange rate markets in June; 3) delays in foreign aid disbursements; and 4) unexpectedly low export receipts.

The rate of inflation by the end of December was 70.8 percent, significantly in excess of the program target of 30 percent, averaging 62.7 percent in 1994, as the broad money supply increased by 49 percent and credit to the economy expanded by 65.5 percent. Much of the increase took place in January (9.3 percentage points) and December (11.3 percentage points). The major increases in the CPI came from: energy as fuel prices increased[3]; industrial products, contributing 12.8 percentage points to inflation; meat, fish, milk and eggs, contributing 9.6 percentage points to inflation; and cereal grains. The prices of fresh produce actually declined by 0.9 percent from the previous year as liberalization of the market continued and became more competitive. Shortages of industrial goods, certain foodstuffs (meat, fish, milk and eggs), and grains played a role, partly due to the changed composition of foreign aid from a normal level of import support funds toward the elections and demobilization. This led to a reduction in imports of the above goods which have a significant weight in the CPI.

Money and credit expansion led to a significantly higher than programmed target for inflation in 1994. The rapid expansion of monetary aggregates in the latter part of 1993 adversely affected price performance in early 1994. High rates of inflation pushed the Central Bank nominal

[3] The large increases in fuel prices in 1993 and 1994 led to significant social unrest in the city of Maputo as people rioted and demonstrated against the pass through of import price increases to the pump. Instead of gradually phasing in the price increases, prices were adjusted immediately which caused considerable hardship to many consumers as transport is a major component of their expenditures.

rediscount rate up to 69.7 percent in November 1994. Unlike inflation in previous years, this could not be blamed by the GRM mainly on the devaluation of the metical, which depreciated 26 percent against the dollar, and the consequent increase in the price of all imported goods. Furthermore, there was no longer any vast differential between official and parallel rates (the differential was maintained at around 13 percent, on average, throughout the year). Part of the cause was the rise in prices that took place in early 1994, which reflected the effect of the rapid growth in the money supply at the end of 1993. In addition, there was the announcement of the Concertacao Social in April 1994, an agreement between the GRM, the trade unions, and the main traders, which set maximum prices for basic foodstuffs[4] which created considerable concern about future scarcities. In the second half of 1994, there was a further increase in the amount of money in circulation, partly due to the increase in the minimum wage decreed in June and the demobilization payments made to tens of thousand of soldiers returning to civilian life. Large amounts of money were also paid out during the electoral process. The large presence of the United Nations peacekeeping force in 1994 (as in 1993) also played a role as they spent more than $1 million per day, much of which entered the local economy.

Inflation through the growth in money was driven in large part by the banks not adhering to credit ceilings and by an expansion in other items net. The increase in net domestic assets, particularly in other items net of the banking system, made the GRM out of compliance with the IMF program targets (for, inter alia, net domestic assets, money supply and the bank-by-bank credit ceilings) and further exacerbated the liquidity crisis. The central bank took stronger measures to control monetary supply in the last quarter of 1994 when it began to more strictly enforce credit ceilings and charge higher penalties. Inflation remains a primary concern and the reform of the central bank and the dominant state-owned bank as well as reforming instruments of monetary policy, financial policy and enterprise reform are important steps in addressing the root causes of inflation, which has been a major source of macroeconomic instability for several years. The GRM announced in early 1995 that they will pursue the following measures to control inflation: 1) rationalize public expenditures in order to avoid a situation whereby the state absorbs resources that should be used by the private sector; 2) make significant repayments to the banking sector to ensure adequate levels of credit to the private sector; 3) control monetary expansion on a quarterly basis by limiting net domestic assets in a manner consistent with economic growth and the reduction of inflation; 4) control monetary policy on a weekly basis by monitoring the increase in base money, net credit to government, external reserves of the central bank and the exchange rate; and 5) maintain the rediscount rate of the central bank at a positive level in real terms in order to penalize banks that do not meet the required level of reserves. Complementing these policies will be continued financial and enterprise sector reform.

II. Prices

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[4] Although officially announced, it was never put into practice as evidenced by prevailing prices in the markets. The action, to which the GRM was only a 'signatory' agent, was primarily done to appease labor unions, who have seen their purchasing power significantly erode over the last five years before the elections.

After independence, the new government administered prices and allocation of most basic goods, including marketing of agricultural products. Extensive administrative controls on prices and allocation continued during the 1980's which introduced rigidities and disincentives that prevented efficient allocation of resources. As shortages increased, barter, inflation and parallel markets for goods and foreign exchange became widespread.

Prices for virtually all agricultural crops were set centrally by the National Price and Salaries Commission. A high priority was the setting of prices on a pan-territorial basis which were often left unchanged for long periods of time. Official producer prices for major crops were left constant for as long as seven to nine years (see the Agricultural component of the Gross Output Section). It is difficult to ascertain these prices in real terms, given the repressed nature of inflation resulting from the highly controlled economic structure in Mozambique at the time. The situation of repressed inflation which resulted from financing of deficits through money creation undermined attempts to restore price incentives. However, it is clear that the relative terms of trade of agricultural producers declined drastically in the 1980's (see the agriculture component of the Gross Output section) and by the mid-1980's real terms of trade had deteriorated significantly for most producers. Even in the years preceding the sharp rise in the CPI, the purchasing power of the metical dropped in rural areas more as a result of extreme scarcity of goods to buy than as a result of price inflation per se. When goods were available, they were often sold outside official channels at prices well above official levels.

One of the first steps toward liberalizing agricultural pricing and marketing was the freeing of vegetable and fruit prices from administrative controls in 1985[5]. This liberalization resulted in a substantial increase in production, primarily in the relatively secure green zones surrounding the principal urban markets of Maputo, Beira and Inhambane. The success achieved with this initial effort paved the way for more radical subsequent reforms in response to continuing declines in marketed output. There were 46 product groups in the agriculture, industry, and service sectors with fixed prices in 1986 [6]. The remaining agricultural prices, e.g. cassava, were free of control, while the remaining industrial products were subject to conditioned prices.

Overall, the ERP was designed to promote growth based on Mozambique's abundant agricultural resources through a program of liberalization of marketing and prices. However, the GRM remained committed to centralized distribution of consumer goods and government-guaranteed markets for smallholder production since the security situation prevented private reestablishment of the rural trading system. In contrast to policy before 1984, which placed emphasis on increasing production in the state farm sector, the new strategy under the ERP adopted in 1987 was directed toward increasing incentives to market production from the family farm sector (smallholders). In particular, it was recognized that the system of fixed prices had gradually

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[5] USAID played a major role in the liberalization of vegetable and fruit prices.

[6] There were also fixed tariffs on the transportation sector.

eroded incentives for marketing output from the smallholder sector. Also, the extreme scarcity of consumer goods represented a significant constraint to the effectiveness of price incentives.

For those agricultural products that continued to be subject to fixed pricing, there was a move toward international prices, although limited. Prior to the ERP, domestic producer prices were seriously misaligned with international prices. At the prevailing exchange rate, the price for most products exceeded the international price by a considerable margin (partly to offset the exchange rate distortion). Given a more realistic exchange rate, domestic prices were clearly out of line. In 1986, no product prices exceeded 20 percent of the international price.

A comprehensive set of exchange rate, wage and price measures were taken during 1987-1989. The metical was devalued by a cumulative total of over 94 percent in foreign currency terms, from MT 39 to MT 820 by the end of 1989. The first steps toward realigning prices and restoring incentives were two large devaluations of the metical; by 80 percent in dollar terms in early 1987 and by another 50 percent in June of the same year. These moves had an immediate effect on both the official foreign exchange market and on the parallel market, where rates for the U.S. dollar exhibited a tendency to converge to the newly devalued official rate from about 1500-1800 Meticais per dollar to about 1200 by 1988. Though quite variable, the parallel rate remained at a level about 100-200 percent higher than the official rate through 1990. By mid-1991, the official rate had reached 1500 Meticais per dollar, with a parallel rate about 75 percent higher.

For those products subject to fixed producer price controls, prices were raised in 1987 by up to 1000 percent compared to prices at the end of 1986 to reflect the impact of the devaluations. In addition, prices of goods distributed through the ration system (see below) were increased several fold in order to alleviate the burden of consumer subsidies on the budget and to avert a long-term dependency on subsidization. However, given the rigidity and inefficiency of the ration system, there were chronic shortages and evidence indicates most consumers purchased commodities in the parallel market. Housing rents were also increased in May 1988. Increases in regulated prices, i.e., prices subject to a specific formula and approved by sectoral ministries, were permitted subject only to an ex-post review rather than prior approval as had previously been the case. Additional autonomy, although limited, was provided to enterprise manages in hiring and firing labor and in the determination of pay to reflect productivity improvements.

Nominal industrial prices also experienced rapid increases over the 1987-1989 period. Fixed prices were adjusted to reflect the exchange rate changes. The remaining products, which were all subject to the conditioned price legislation, were adjusted regularly and with little GRM constraint. While the basic legislation was unchanged, the system was made more flexible from the onset of the ERP with price changes no longer being subject to prior approval. Instead, changes required only the ex-post review of the appropriate ministry. Enterprises therefore had the freedom to pass through the costs of depreciation without delay. Estimates from a Business Environment Study in 1989 indicate that official industrial prices moved closely in line with the exchange rate changes. Between December 1986 and December 1988, the sample showed prices increased by about 1570 percent, compared with the depreciation of 1450 percent. The sample included both imports and domestically produced products. In general, the price of imported products moved in line with currency adjustments[7] and this was reflected in both intermediate and final product prices.

Consumer subsidies increased significantly in 1987 as a result of the price adjustments following the devaluations that took place during the year. Government policy was initially directed at both reducing the implicit taxation of producers and at cushioning the impact of this policy on consumption by increasing the consumer subsidy. As a result, the subsidy increased to 7.5 percent of current expenditures in 1987. In 1988, however, the direction of policy shifted and a vigorous effort was made to reduce both the implicit producer tax burden and the consumer subsidies, through substantial consumer price increases in April 1988 and May 1989.

As a result of the exchange rate adjustment, together with the freeing of many product prices and the adjustment of fixed prices, consumer prices increased sharply in 1987 by 163 percent but the rate of price adjustment decelerated considerably in 1988 to about 50 percent. The rates of price adjustments largely reflected the policy adjustments implemented under the ERP, particularly the exchange rate changes and the substantial reduction in consumer price subsidies.

The evolution of agricultural pricing policy since 1991 has been toward a steady increase in the reliance of the GRM and the economy on market-based prices with occasional significant slippages. The marketing margin for domestically-produced maize was freed in May 1990. A further advance in price policy was made in May 1992 when, as part of the GRM annual establishment of cropping season minimum (floor) price for four other principal domestically-produced marketed crops (maize, rice, beans, groundnuts and sunflowers), marketing margins were liberalized. This allowed free pricing of the marketing margins between the producer and the final consumer. However, prices on imported maize and milled rice and maize continue to have fixed prices and marketing margins.

A more significant breakthrough occurred in July 1993 when the GRM decreed that consumer prices on a large number of food goods were liberalized in the pursuit of "development of free competition in the market." Maize meal, cooking oil and rice were among the goods covered in this decree. Prices of 22 more products were freed in August 1993. Administered consumer prices are now limited to two basic foodstuffs (wheat flour and bread), rents, fuels, utilities, newspapers and certain hotel tariffs and transportation fares. The conditioned price system applied to eight goods[8] produced under monopolistic conditions was eliminated in April 1994. The GRM is planning to revise urban residential and commercial rents in 1995 which have been

[7] Import prices at the time bore a relatively weak relationship to international market prices in some instances, since a large proportion of these products were financed through external donor aid. In the case of tied aid, prices were donor determined and were often considerably in excess of market prices.

[8] Beer, tea, matches, batteries, cement, tires, pesticides and coal.

basically frozen since 1991.

As the economic reforms undertaken by the GRM began to show fruition, the Mozambican economy began to exhibit strong growth. A down side of this growth was the corresponding inflation that had a particular negative impact on the lower income people in the country. In response to rising prices, a proposal (the Social Compact) was developed in mid-1994 among a major labor union, business organizations and some elements of the GRM to fix prices on a number of food commodities in the Maputo area. The proposal was structured to accommodate everyone. Traders, e.g., were to get exemptions on the circulation tax and a 50 percent reduction in customs duties on imported food goods and other goods under the proposal. These goods included yellow maize and maize meal, rice, sugar and cooking oil. In return for this financial benefit, the traders agreed to a 7 percent cut in their profit margins. The unions, on the other hand, sought an indexing of the minimum wage to inflation and agreed not to call a general strike. The GRM benefitted from not having a politically embarrassing event occur right before the elections. The agreement was signed by all parties.

The day after the agreement was signed, the Ministry of Agriculture (MOA), released a study on the proposal. Using the data from a USAID-sponsored project, the study noted that the existing market prices for yellow maize and, in most cases, rice were below the fixed price of the proposal. Sugar and oil prices were higher than the stated fixed price. It was evident from the study that traders in corn and rice could actually increase their profits by raising their prices to the higher fixed price to the detriment of poorer consumers, few of whom earn formal sector, trade-union protected wages.

A formal renouncement of the proposal was never done[9] but, de facto, the fixed price proposal never happened because the GRM never allowed the exemption of the circulation tax and reduction of customs duties and traders continue to set their prices according to the market. However, early in 1995 labor unions were back in consultation with the GRM on implementation of the Social Compact.

A. USAID Monitoring of Consumer Prices

The USAID/Maputo Mission has tracked open market consumer prices of a selected group of basic commodities since April, 1990. Prices have been tracked for yellow maize grain and flour, white maize grain and flour, three qualities of rice, brown and white sugar, groundnuts, two varieties of beans, three qualities of vegetable oil, salt, soap, charcoal and beer. The evolution of a selected group of prices is shown graphically below. Data were collected for open market prices and official prices were tracked. The graphs illustrate the acute price differentials (and, therefore, the lack of any relationship between the official and open market prices), except for low-grade vegetable oil, between the official and parallel markets as the GRM sought to keep

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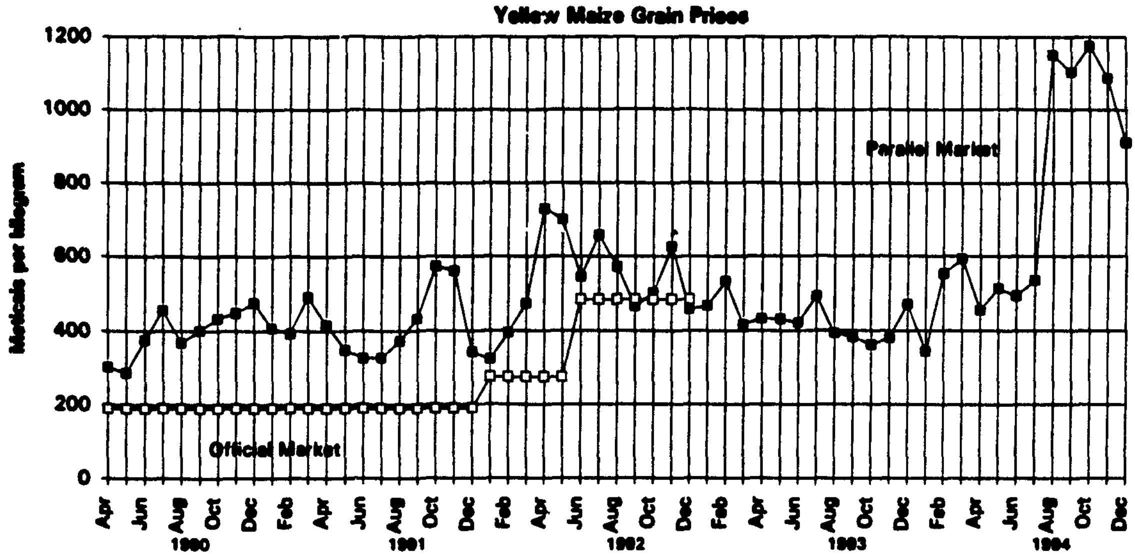
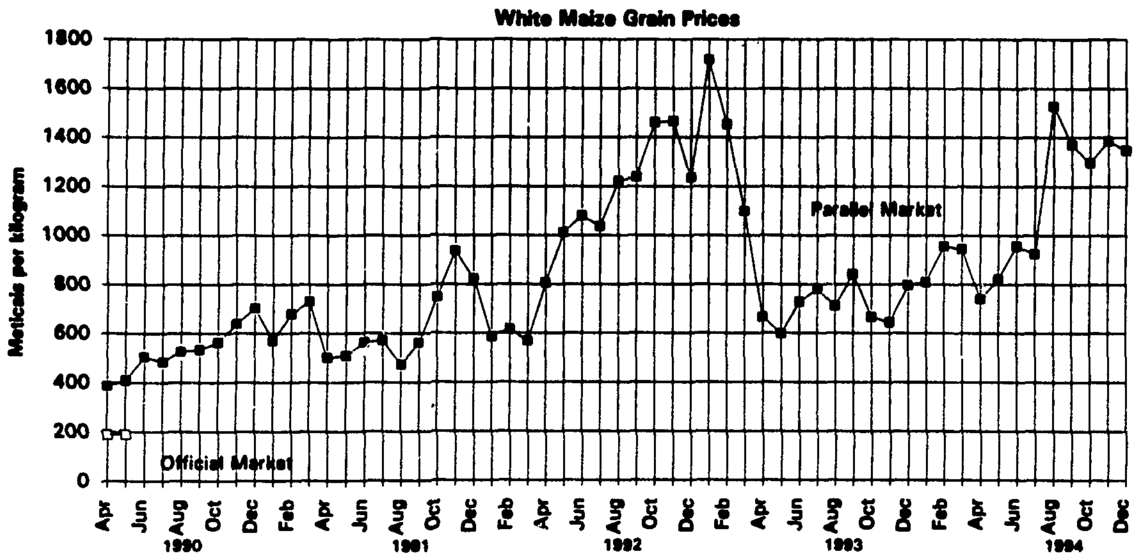
[9] The exception was the price of yellow maize which constituted a violation of USAID's Title III agreement.

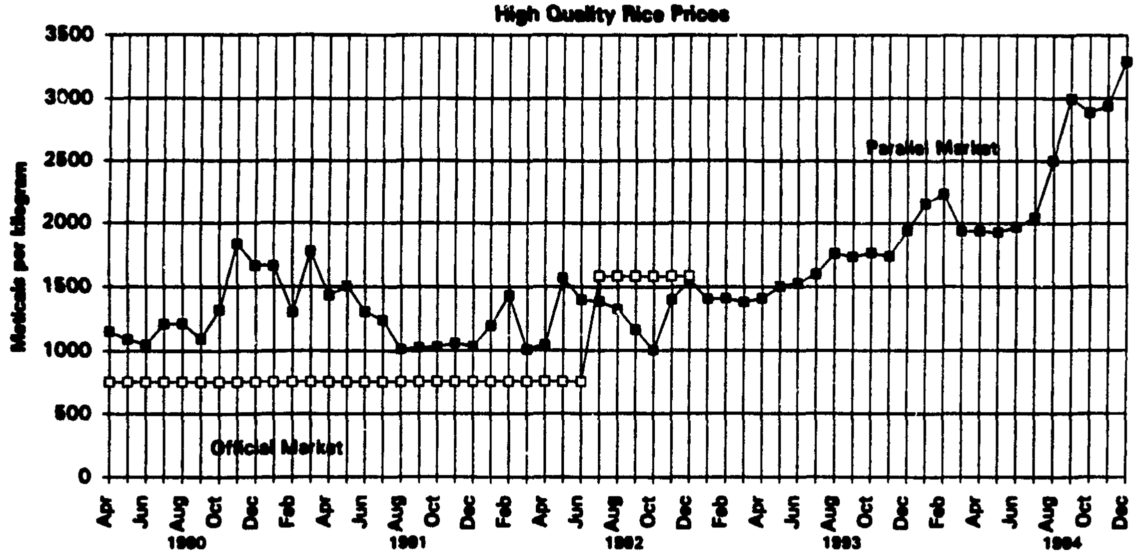
consumer prices artificially low. The trend of the prices graphed below indicates a sharp movement upward, especially since 1992, the year of the drought and the demise of the ration system (yellow maize grain, rice, sugar, vegetable oil, beans and soup, as noted above, were sold through the ration system at artificially low prices). Consumer prices of groundnuts and beans were liberalized in 1991. Sugar, vegetable oil and soap were moved to the conditioned price list in 1992 and rice and sugar were added in early 1993 before being fully liberalized.

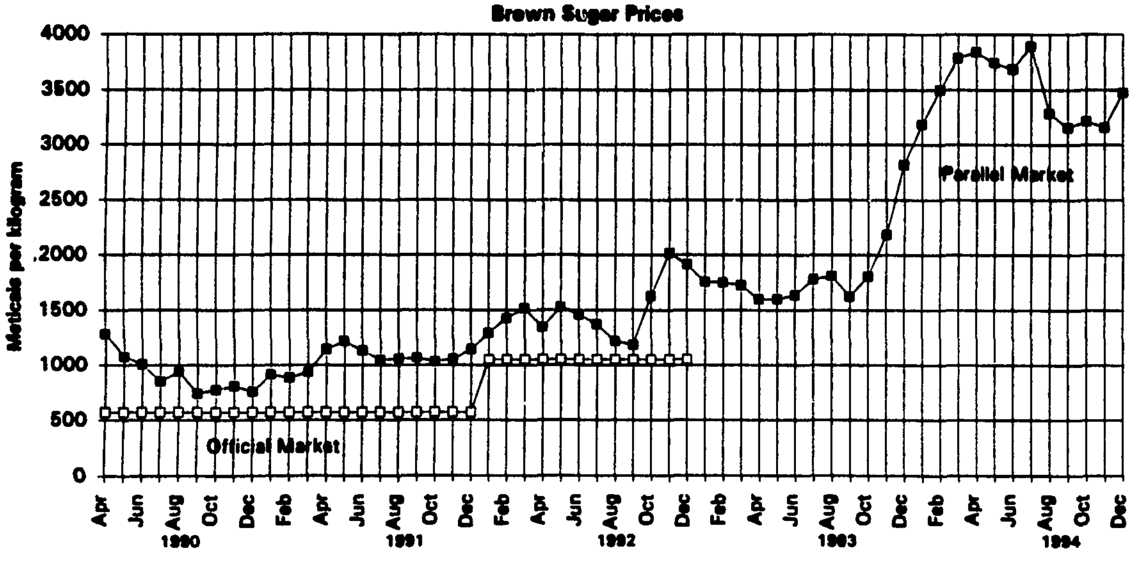
1. Maize, the Staple Food Crop

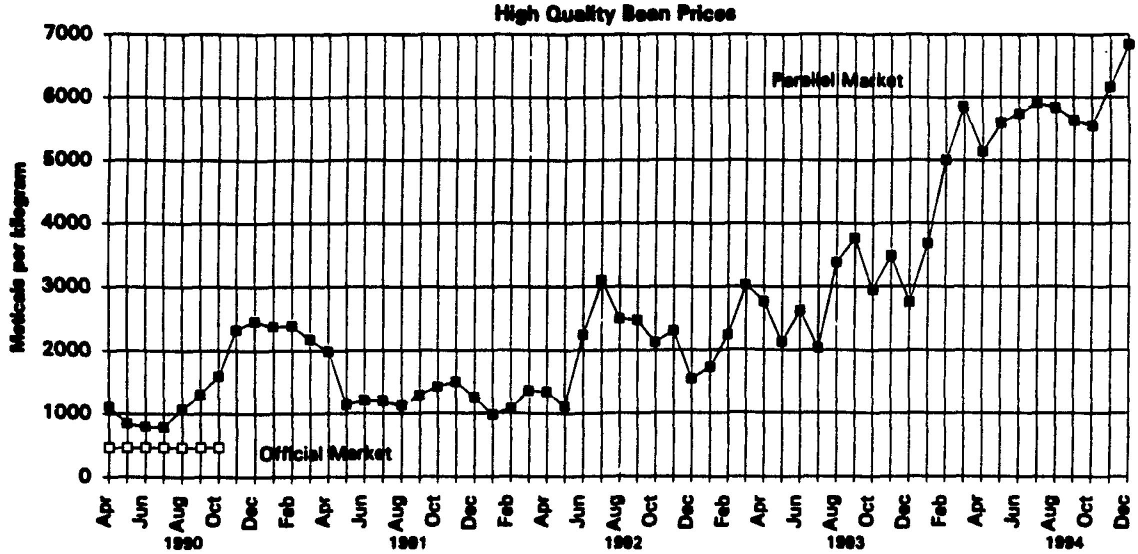
Since USAID food aid began in 1985, white and yellow maize have become close substitutes but in general, households prefer white maize when it is available, depending upon the relative prices of the two grains. As can be seen from the two graphs below, their prices tend to move together, except during times of great scarcity, e.g.., there was an acute shortage of white maize at the end of 1992 and the beginning of 1993. Imports of yellow maize represent an important source of food for lower income consumers, particularly during periods of scarcity for white maize, the basic staple crop. The prices of yellow maize are strongly influenced by food aid arrivals. White maize prices, in turn, are strongly influenced by yellow maize prices. The GRM sold yellow maize at prices below import parity in line with the humanitarian objective of donors as they believed that this practice would not hamper domestic production of white maize. Research by Michigan State University (MSU) indicated that continued large volumes of yellow maize food aid sold at artificially low prices would create disincentives to the production and marketing of white maize. More importantly, it is now recognized by the GRM that artificially low prices aren't necessary. What is necessary is stability of supply and price and choices among products. As a result, the GRM and donors are beginning to move closer to import parity pricing of maize.

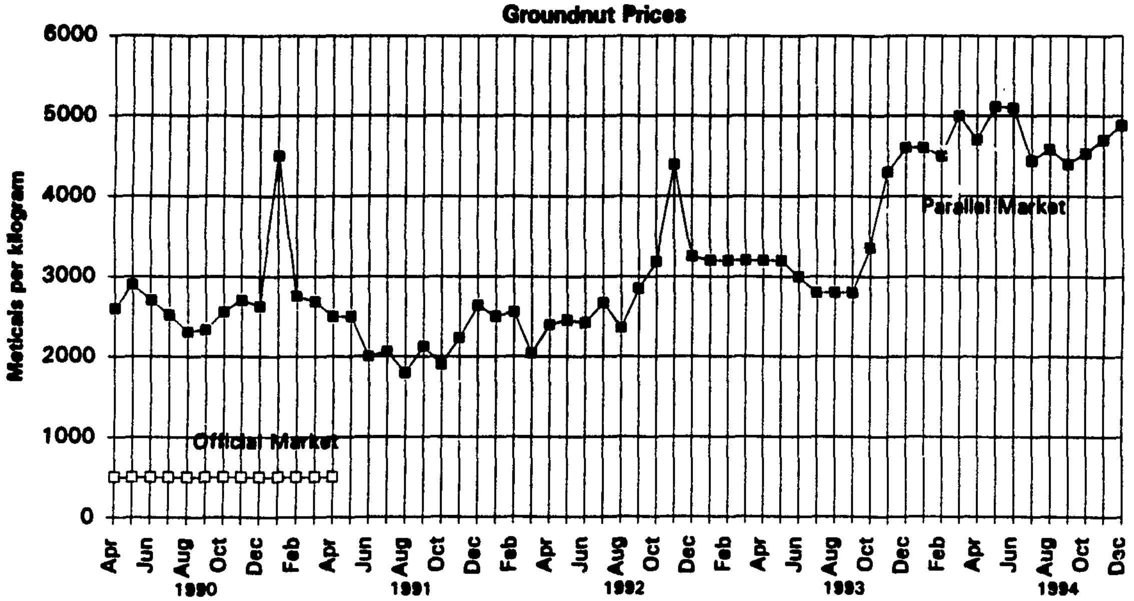

Yellow Maize Grain Prices
Meticais per kilogram
Parallel Market
Official Market
1200
1000
800
600
400
200
0
Apr Jun Aug Oct Dec Feb Apr Jun Aug Oct Dec Feb Apr Jun Aug Oct Dec Feb Apr Jun Aug Oct Dec Feb Apr Jun Aug Oct Dec
1990
1991
1992
1993
1994

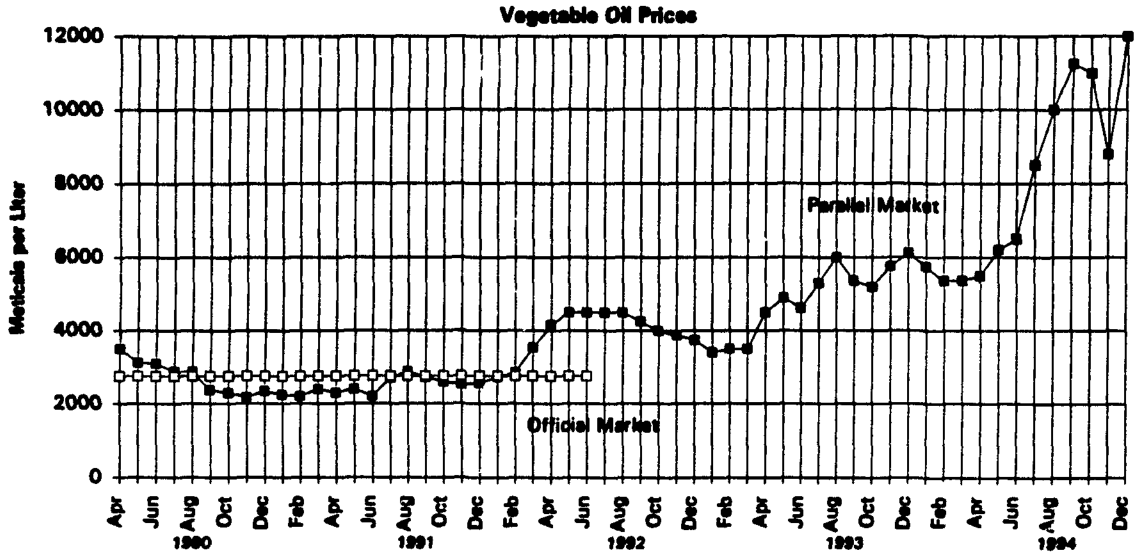

White Maize Grain Prices
Meticais per kilogram
Parallel Market
Official Market
1800
1600
1400
1200
1000
800
600
400
200
0
Apr Jun Aug Oct Dec Feb Apr Jun Aug Oct Dec Feb Apr Jun Aug Oct Dec Feb Apr Jun Aug Oct Dec Feb Apr Jun Aug Oct Dec
1990
1991
1992
1993
1994

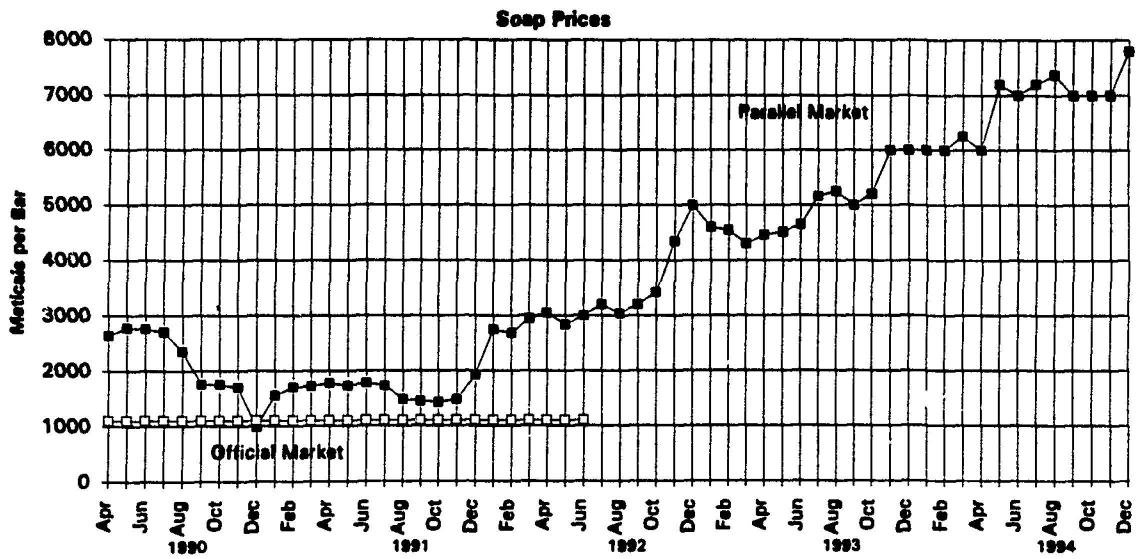

High Quality Rice Prices
Meticals per kilogram
3500
3000
2500
2000
1500
1000
500
0
Parallel Market
Official Market
Apr
Jun
Aug
Oct
Dec
Feb
1990
1991
1992
1993
1994


Brown Sugar Prices
Meticals per kilogram
4000
3500
3000
2500
2000
1500
1000
500
0
Parallel Market
Official Market
Apr
Jun
Aug
Oct
Dec
Feb
1990
1991
1992
1993
1994


High Quality Bean Prices
Meticals per kilogram
Parallel Market
Official Market
Apr Jun Aug Oct Dec Feb Apr Jun Aug Oct Dec Feb Apr Jun Aug Oct Dec Feb Apr Jun Aug Oct Dec Feb Apr Jun Aug Oct Dec
1990 1991 1992 1993 1994


Groundnut Prices
Meticals per kilogram
Parallel Market
Official Market
Apr Jun Aug Oct Dec Feb Apr Jun Aug Oct Dec Feb Apr Jun Aug Oct Dec Feb Apr Jun Aug Oct Dec Feb Apr Jun Aug Oct Dec
1990 1991 1992 1993 1994


Vegetable Oil Prices
Meticals per Liter
12000
10000
8000
6000
4000
2000
0
Parallel Market
Official Market
Apr
Jun
Aug
Oct
Dec
Feb
1990
1991
1992
1993
1994


Soap Prices
Meticals per Bar
8000
7000
6000
5000
4000
3000
2000
1000
0
Parallel Market
Official Market
Apr
Jun
Aug
Oct
Dec
Feb
1990
1991
1992
1993
1994

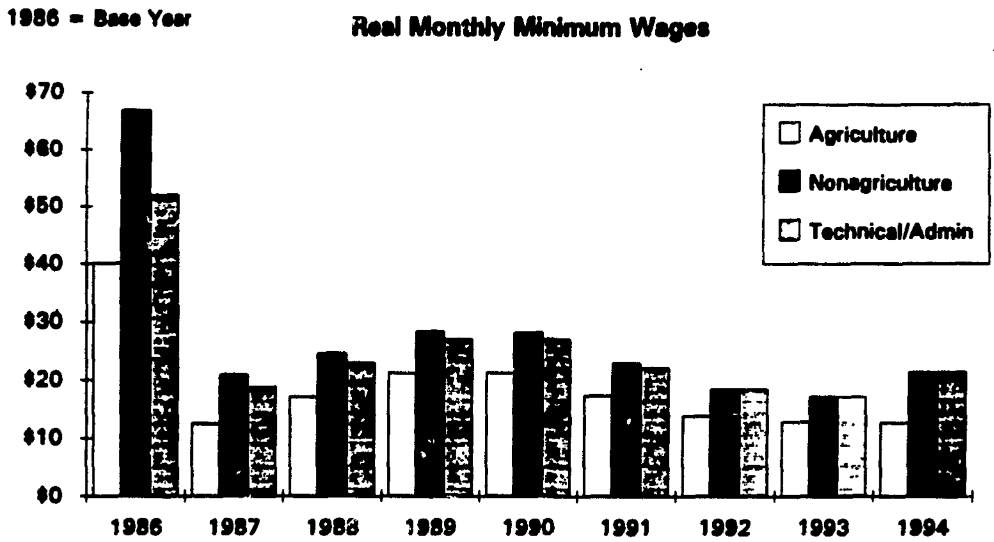
III. Wages

The only wage indicators available in Mozambique are the minimum monthly wage scales, which are established for three labor categories (agricultural, non-agriculture and technical/administrative levels) by the Council of Ministers. There are no reliable data on private sector wage trends (see the following section for the results of some surveys).

The supply of consumer goods and marketed crops contracted sharply during the early 1980's. However, monetary aggregates moved in the opposite direction and increased sharply. Deficit financing of non-performing enterprises and unrealistic wage rises contributed to a loss of monetary control. The average wage bill was $260 million above the value of goods on sale in 1983. Combined with officially controlled prices, this generated parallel markets, where officially suppressed inflation emerged. Many people increasingly favored barter over money as a means of exchange.

The GRM's wages policy since 1986 has risked extreme political discontent by restraining wage increases to rates far below inflation and by encouraging a greater differentiation of salary scales. At the start of 1987 a national director's salary was 66 percent higher than that of the highest level director's secretary. By the end of 1989 this gap had widened to 237 percent. Within the technical/administrative level, at the beginning of the same period, a specialist earned MT 44,550 ($60) a month more than the lowest technical assistant. By the start of 1990 he/she earned MT 137,607 more. In December 1990 the principle of collective bargaining between companies and workers was approved. The GRM has restricted itself to setting minimum wages for all registered enterprises. In December 1991, the minimum wage was raised to MT 40,000 ($27) per month in the urban sector (non-agriculture and technical/administrative areas) and MT 30,000 ($20) per month for agricultural workers. This minimum fell dismally short of the amount needed to cover even the most basic survival requirements for an average-sized family. The minimum wage for urban workers was increased to MT 117,200 and for farm workers to MT 88,000 in mid-1994. A further increase of 35 percent was enacted in February 1995.

During implementation of the ERP, budgetary expenditure on wages and salaries was targeted to increase by around 120%. This increase was projected to permit an approximate constant average real earning level, using the CPI as the relevant index of consumer prices. However, in 1987 expenditures rose by less than 90 percent, with the CPI at the time rising by 163 percent. In 1988, the real wage bill rose substantially to more than offset the price adjustment, allowing real earnings to increase steadily. Real wages fell over 1990-1991. Although the scales have been increased six times since April 1989, minimum wages have suffered a progressive purchasing power erosion during 1989-1993 that reversed the gains obtained between 1987-1989. This development resulted from the acceleration since 1990 in the inflation rate that was never fully offset by the lagged adjustments in minimum wages, which had been based on past inflation.



IV. Labor, Income and Employment

The situation of the labor market is difficult to assess, given the lack of reliable and comprehensive data (in some cases nonexistent) on wages, employment, labor force and productivity. In addition, the mass movement of a significant portion of the population because of the war and periodic natural disasters contributed to the difficulty of gathering information. Mozambique suffers from widespread absolute poverty that is estimated to affect some 60 percent of the population[1]. In 1992, there were an estimated six million displaced people (out of a total estimated population of 16 million), most of whom were forced to survive in crowded refugee camps and urban slums.

Information on living standards is very limited but it is indisputable that the majority of Mozambique's population is poor. A national household study will be implemented in 1995 to generate information for policy. Enough information exists, however, to form initial priorities. Most poor people are rural or originate from rural areas. About 60-70 percent of rural households are poor and about one-third of the urban population is poor (40 percent in Maputo).

The subsistence and informal sectors still provide the only income source for an estimated 90 percent of Mozambicans. Of the recorded wage labor workforce in 1993, 47 percent were employed in the shrinking industrial sector and 28 percent in transport and communications. The

[1]Based on the number of households meeting one of two extreme poverty criteria employed by the UN: 1) daily caloric intake below two-thirds of the minimum requirements; or 2) prevalence of growth faltering in children.

civil service employs around 105,000. The main features of the labor market are typical of a developing country: an excess supply of unskilled labor, acute shortages of skilled labor and very low productivity levels. Since 1990, the problems of unemployment have been compounded by the return of emigrant workers from the former German Democratic Republic and South Africa. Tremendous pressure is being exerted on the labor market and its weak institutions by large numbers of returning refugees, displaced and disabled persons, demobilized soldiers and retrenched workers. Within the scope of the peace process, the GRM is working with donors on resettlement and training programs to minimize further increases in unemployment arising from the military demobilization. There is no comprehensive employment policy in Mozambique and the labor market information system is ineffective. The institutional weakness is exacerbated by the gradual withdrawal of the government from productive activities and mobility of skilled labor from the public to private sectors of the economy and to donor-funded projects[2].

After independence, the GRM was faced with the task of developing an administrative structure capable of running a highly centralized, large state-owned economy. The public service sector eventually exceeded 100,000 (the only sector that grew significantly over the post-independence decade). Technical and vocational education policy was not sufficiently directed toward the needs of production, although a number of vocational training centers were established to fill the vacuum left by the 180,000 (out of a total of 200,000) Portuguese who left at independence.

A large number of Mozambicans have historically worked outside the country, mainly as migrant workers in the South African mining industry, but also in South African agriculture, construction and manufacturing. During the period after Mozambican's independence, the South African mining industry underwent significant changes. Higher gold prices and progressive labor legislation led to sharp increases in wages and improved working conditions, resulting in the internalization of labor, i.e., a reduced dependency on foreign labor because of the greater availability of domestic labor. The fear of Communist agitation from Mozambican labor and the unexpected withdrawal of Malawian labor, made the mines vulnerable to the supply of foreign labor. Naturally, this caused considerable concern to the GRM which, despite calls for reducing dependency on migrant labor (in concert with other Southern African countries), tried to negotiate for the doubling of recruitment levels during discussions following the Nkomati Accord of 1984. There was a slight increase in recruitment after 1984 but in October 1986 South Africa announced a ban on Mozambican migrant labor. However, pressure from South African employer organizations, particularly the Chamber of Mines, led to the exemption of long-serving and experienced Mozambican mine workers from the ban. The ban on novice recruitment and less skilled miners was officially lifted in November 1988. According to figures from the South African Chamber of Mines, the number of Mozambicans employed in its affiliated mines at the time the ban was lifted was 47,000, down from 60,000 in October 1986. The number rose to 48,991 in 1989 but the crisis in the South African mining industry minimized further increases. The Employment Bureau of Africa (TEBA), the agency used by the Chamber of Mines in South

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[2]The importance of this issue is illustrated by the fact that it was discussed at a side session at the 1993 Consultative Group meeting in Paris.

Africa to pay remittances, paid Mozambique a total Rand 152.58 million ($53.7 million) in 1991. Under the official agreement 60 percent of the workers' earnings is transferred to the Mozambican central bank, which pays out the equivalent in Meticais at the prevailing exchange rate. The miners themselves bring in foreign exchange and goods and equipment when they return to Mozambique. Nearly 13,000 Mozambican migrants were also registered as legal farm workers as of November 1986. These are now being allowed to re-register annually. Any other Mozambican workers in South Africa are regarded as illegal immigrants, and it is South African policy to deport them to Mozambique. However, this frequently happens only after they have provided extremely cheap seasonal labor to farmers at harvest time.

In addition to employment in South Africa, 15,000 Mozambicans were also employed in former East Germany on various "on the job" training programs until 1990. With the reunification of East and West Germany, the arrangement was abruptly halted, resulting in a loss of foreign exchange earnings of about $16 million annually (and the loss of a significant route for the national airline).

The adoption of the ESRP and its predecessor the ERP succeeded in arresting the marked economic decline experienced in recent years. However, the short-term impact on the labor market of the ESRP had some negative consequences. Public sector employment in 1987 was cut by around 10%. Inefficient public enterprises bloated with redundant labor, along with a highly bureaucratic public service, were forced to retrench employees (often as much as 40 percent of their payroll). This situation contributed to the massive explosion of the informal sector, particularly in the urban areas. The worsening unemployment crisis, however, was not limited to Mozambique. The Southern Africa region was undergoing a significant recession and confronting unprecedented unemployment levels.

The Mozambican labor market is characterized by high labor force growth rates, declining wage employment and real wages, acute skill shortages and a rapidly growing urban informal sector. All of these factors reflect a depressed labor market and increasing poverty. It is estimated that in 1990 7.8 million people were in the labor force (out of a population of about 16.2 million), indicating a labor force participation rate of 48 percent.

Unpublished data from a 1991 population survey indicate that agriculture accounts for 80 percent of the total employment in the country. Wage employment accounted for only 17 percent of total employment. A new feature of employment status in 1991 was the huge size of self employment (family sector), which accounted for 46 percent of total urban employment. In 1980 this sector was virtually absent. The displacement of people to urban areas has created a large urban informal sector.

The Mozambican civil service employs around 105,000 Mozambicans. There are considerable problems of remuneration, shortages of skilled personnel and uncoordinated management policies. Remuneration problems include: 1) pay levels which are below those prevailing in the economy at high and middle level grades; 2) the pay structure which varies considerably across ministries and lacks salary increments within grades; 3) a widespread practice outside the public sector of paying substantial portions of wages and salaries in foreign exchange. These problems result in high turnover, extreme difficulty in recruiting and keeping skilled personnel, and widespread tax evasion.

In spite of the initial policies adopted under the ERP, the employment policies of the last two decades have resulted in redundant labor in state enterprises. Very few state companies have undertaken a reduction in their work force by using severance pay. There are two main constraints to reducing the public labor force. First is the fact that most SOE's are in financial difficulty and do not have the cash to pay the legally-mandated severance pay. For example, a worker that has been employed with the firm for sixteen years would require that the company pay 24 months of salary as severance pay. This presents a prohibitive cash-flow problem despite the fact that the average salaries in the industrial sector are only about $38 per month and the non-agricultural minimum wage is $17 per month. The current system also encourages firms to lay off their newest workers, rather than trying to develop an early retirement package for older workers. The second constraint is the simple fact that the GRM is especially sensitive to laying off workers. Labor unions have a strong and important role at both the firm and national level. After years of Marxist policies, workers and unions feel they have some ownership of state enterprises and a right to a job at those enterprises.

Faced with difficulties in reducing their workforce combined with other operating constraints, SOE's with cash-flow problems have difficulties in paying their wage bills. Consequently, many companies ask all or part of their workforce to stay at home. While base salaries must be paid, the cost of providing transport, food and health benefits are thereby reduced. Nevertheless, for paralyzed or inactive firms the wage bill continues to constitute a large fixed cost. Many companies are not able to pay salaries at all but accumulate debt in the form of salaries in arrears instead. These firms are also not honoring their pension obligations. In the industrial sector, many companies have not paid salaries in over six months. In the agricultural sector this non-payment of salaries has lasted over two or three years (some of the remaining state farms have given workers pieces of the farm to cultivate for themselves in lieu of salary). In several instances the non-payment of salaries has led to labor unrest and strikes.

The current labor law (written in 1985 prior to reform) is outdated and irrelevant to a non-command economy, e.g., it provides no guidance regarding labor issues arising from privatization. Specific areas requiring change are the need for flexible contracts, streamlined procedures for disciplinary dismissal and for a revision of the formula for severance pay. In the absence of applicable law, a Tripartite Commission of government, union leaders and management representatives meets regularly. Although they have a mandate to resolve outstanding labor issues and initiate preliminary discussions regarding the revision of the labor law, nothing definitive has yet been enacted.

A. Profile of Urban Households

Significant urban poverty exists in Maputo, other cities such as Beira, and small rural towns. Survey evidence is fragmentary but up to one-third of the urban population is estimated to fall below the poverty line. In Maputo, about 40 percent of the city's population falls below a poverty line based on minimum food requirements. Informal employment provides the main source of income for the urban poor with very few having sources of income from the formal sector. The urban poor typically lack the skills and capital to directly engage in the most profitable activities such as informal manufacturing. High rates of labor force participation, including the participation of children, characterize poor households. The loss of jobs in the formal sector has increased the reliance of urban households on informal employment, resulting in downward pressure on average incomes. Both underemployment and unemployment rose in Maputo, Beira and the provincial capitals with the disruption of war to their urban economies. Small-scale trading, particularly the sale of food, accounts for most of the informal activities of the urban poor, especially women. Informal employment is particularly important for poor women. Nevertheless, the urban informal sector is vigorous and displays considerable skills of entrepreneurship. The growth of the trade in food between the green zones around Maputo and the city's markets, an activity which is predominantly run by women, is one example of the dynamism of the informal sector. The current challenge is to raise the productivity of micro-entrepreneurs and to diversify their activities, thereby creating income and employment for Mozambique's urban poor.

A USAID-sponsored survey[3] of urban and peri-urban households in and around Maputo provides some interesting insights on the economic activities of urban households. A sizeable number of households (28 percent) reported having at least one family member living outside of Maputo, although very few reported receiving remittances. Houses tended to own multiple plots of land in rainfed and irrigated areas, although registered households held fewer but larger plots than unregistered households due to fewer holdings of rainfed land. Female-headed households were particularly disadvantaged. While they had fewer dependents (18 percent fewer residents), their irrigated land holdings were roughly one-third the size of male-headed households.

Only 7 percent of households on average had one or more members who belonged to a cooperative but 65 percent had a member who belonged to a producer association, with non-registered households having higher rates of membership in producer associations than registered associations, with rates of membership between male-headed and female-headed households nearly equal. Those families belonging to a cooperative tended to join for reasons of gaining access to farm inputs, obtaining produce to sell in the market, increased access to land or for marketing assistance. Those families with membership in a producer association tended to join to increase security of land rights and to acquire farm inputs.

In terms of formal sector employment, many activities were part-time positions and multiple activities were often worked by one wage-earner. The construction/industry and

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[3] Conducted over 1991-1992.

service/administration sectors were the most significant sources of wage employment for both males and females. Males participated to a much higher degree in than females in formal wage employment. While the number of adult males and females in the sample survey were approximately equal, female labor represented 20.3 percent of formal sector activity while time worked by men accounted for 79.7 percent. Women earned less than men in formal sector activities except in the restaurant/hotel sector where women earned higher average monthly wages than men. In all other categories monthly wages for men were 9 percent to 77.8 percent higher than those for women. The average monthly wage across activities was MT 50,800 (MT 38,500 for women and MT 54,000 for men[4]).

With the liberalization of Mozambique's economy, self-employment, particularly petty trade, became an important part of household income strategies. In addition to conventional activities (artisan, service and commercial sectors), self-employment activities also include agricultural industry (raising animals for sale, fishing and milling). The above activities are not included in farm income because the activity takes place away from the machamba (small farm plot) on the coast (fishing) or at the place of residence (livestock and milling). Although fewer adults reported self-employment relative to wage employment, net monthly incomes from self-employed activities are considerably higher. The overall monthly wage for self-employment was MT 166,200 per worker compared with MT 50,800 per worker for wage employment. Average net monthly income was the highest for poultry, fishing, grocery stores and transportation (all earning over MT 300,000 per month).

Clear market segmentation was apparent in self-employment activities. Men tended to work in all sectors. Women were principally engaged as petty traders in the central and peripheral markets of the city. Of the women reporting self-employment activities, over 90 percent worked in sales of manufactured items and agricultural goods and food, compared with less than 10 percent of males in the same activities. The earnings of women were much lower than those of men. The average monthly earnings of men were MT 232,900 versus MT 48,100 for women[5].

The analysis raised the obvious question of why household members worked in wage employment given the higher earning potential of self-employment activities. Part of the answer was in other benefits offered along with wages in formal sector employment: 52.1 percent of households received retirement benefits; 49.6 percent received medical benefits; 33.9 percent received credit assistance; 28.1 percent received assistance with transportation; and 25.6 percent received food subsidies. The benefits varied widely among strata but the category of female-headed households was most noticeable for lack of access. Only 7.7 percent of female-headed

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[4] Without standardizing wage rates (monthly wages divided by hours or days worked per month), for which information was not uniformly reported, and without adjusting wages for differences in age, education or training, it was difficult to calculate rates of wage discrimination.

[5] As with formal wage employment, earnings from self-employment were not standardized for time worked. Therefore, potential causes for the wage gap (discrimination, unequal access to employment opportunities, lack of resources or time constraints) were difficult to determine from the data.

households had access to medical benefits, 7.7 percent received retirement benefits and 84.6 percent received no benefits whatsoever.

Adults within the household on average held 1.1 salaried positions and worked on 0.4 self-employment activities. The number of self-employment activities was fairly constant across activities. However, the number of formal salaried jobs ranged from 1.3 jobs per household for non-registered households to 0.8 jobs per household and 0.5 jobs per household for registered and female-headed households, respectively. Mean annual non-farm earnings was MT 801,000. Self-employment activities represented 69.5 percent of the total with wage earnings accounting for 30.5 percent. Female-headed households earned MT 292,000 versus MT 854,000 for men. Registered households had the highest absolute level of non-farm income of any category. Compared with non-registered households, the non-farm income of registered households averaged MT 985,000 (versus MT 667,000 for non-registered households), of which 47.1 percent (93.7 percent for non-registered households) came from wage employment and 52.9 percent from self-employment activities. These data indicated both the vulnerable position of women in the formal economy and the stronger economic and social position of registered households relative to non-registered households.

Annual net farm income (crop and livestock activities) of female-headed households was MT 447,000, 89.7 percent from crop income and 16.1 percent from livestock activities. Registered households had the highest annual net farm income of any strata, partly due to larger farm size. Registered households, compared to non-registered households, were able to make more intensive use of the land resource: total revenue - MT 1,012 vs. MT 640 per square meter; wages paid - MT 164 vs. MT 57 per square meter; chemical inputs applied - MT 89 vs. MT 60 per square meter; or net revenue - MT 747 vs. MT 520 per square meter. The productivity of female-headed households was the lowest of any strata and compared with male-headed households, they exhibited very low revenues (MT 437 vs. MT 836 per square meter), wages paid (MT 46 vs. MT 108 per square meter), chemical inputs (MT 32 vs. MT 76 per square meter), and net revenue (MT 358 vs. MT 644 per square meter).

Total household income, including farm and non-farm activities, illustrated the extreme vulnerability of female-headed households to economic fluctuations. The average total income of female-headed households was MT 739,000 versus MT 4,445,000 for male-headed households. Even after adjusting for differences in household size between the two strata, the per capita total income of female-headed households (MT 123,000) was still only 21 percent of the level reported for the male-headed category. Registered households had substantially higher total and per capita income levels than non-registered households, clearly demonstrating the economic power of private (titled) farms in the economy.

On average, crop income contributed 58.7 percent to total household income, livestock activities contributed 16 percent and non-farm activities contributed 25 percent to total household income. Non-registered households (36.9 percent) and female-headed households (34.6 percent) placed the greatest dependence on non-farm employment. Registered households placed the least emphasis on non-farm sources of income (20.9 percent), indicating the combined effect of both greater farm size and greater security of property rights.

B. Profile of Rural Households

While it is indisputable that the majority of Mozambique's population live in households with insufficient income to provide an adequate diet or other necessities, quantitative information on living standards is necessarily limited given the impossibility of conducting national household surveys during the war and the recent mass movement of a large part of the rural population.

The most important source of vulnerability of rural households arises from drought and other natural disasters. The predominantly rainfed (and low-input) agricultural system of Mozambique's smallholders makes them highly vulnerable to the vagaries of climate and to the impact of plant diseases and pests. The war reduced the possibilities for Mozambique's smallholders of using off-farm employment to protect household consumption from the vagaries of weather. Off-farm income provides only 15 percent of total rural income compared to the average of 40 percent found elsewhere in Sub-Saharan Africa. The war also inflicted major damage on the informal safety net by curtailing remittance flows between households and by loosening the ties of family and community. Rural households will remain vulnerable until they have rebuilt their assets, until interregional markets in food grains fully reemerge (to reduce the consequences of local production shortfalls), and until the rural economy has sufficiently recovered to provide enough off-farm rural employment.

The available evidence suggests that between 60-70 percent of rural households fall below a poverty line, defined in terms of a minimum food consumption basket. Nearly all of these depend upon subsistence agriculture in normal circumstances. On a national basis, most of Mozambique's poor, about 90 percent of the total, are rural dwellers, or originate from rural areas, before their displacement by the war. Rural poverty is associated with limited ownership and access to productive assets, low productivity of smallholder agriculture, limited access to market opportunities for cash crops and small amounts of farm income.

During the war many smallholders were driven off the land to become refugees in the towns or neighboring countries. For those remaining, the conflict drastically reduced their ability to access markets, and activity in rural markets dwindled. Smallholders were frequently unable to sell cash crops, purchase food, buy agricultural inputs and consumer goods, or sell their labor. Communities were wary of cultivating land distant from their villages for fear of attack. In many communities, the poorest households had the least access to land close to their villages. Physical insecurity and the risk of losing farm assets to combatants resulted in the drastic decline of investments in livestock, grain storage and capital equipment. As a result, smallholder agriculture in Mozambique at present differs significantly from the system that prevailed before the war and throughout sub-Saharan Africa (SSA) today. Purchased food accounts for only 5 percent of total caloric intake (there is some regional variation as noted by recent research), much less than the SSA average of 15 percent and above. Income from cash cropping and livestock for the last decade has been marginal to household income, again a strong contrast to the African norm. Children of the very poorest rural (and urban) households have very high drop-out rates from school and the adults of these households usually have no education beyond the earliest years of primary school. Very low labor productivity, partially caused by repeated spells of illness, exacerbates the food insecurity of the poorest households and raises further their high morbidity and mortality rates. These factors, interacting with very limited access of poor households to safe water and sanitation, contribute to Mozambique's below average social indicators.

Michigan State University (MSU) has conducted a survey of the northern provinces (Cabo Delgado, Niassa and Nampula) which provides valuable insights into the sources of rural household income. The survey found that on-farm income, crop and animal production, represented a very high level of total income - approximately 85 percent. Off-farm income (cash and in-kind income from off-farm labor, earnings from non-agricultural activities, and remittances) represented an important but significantly smaller proportion. Remittances only accounted for 0.6 percent of total gross household income. These results, of course, will differ to some extent from other geographic regions. For example, small livestock are an important source of rural household income in the southern provinces (approximately 35 percent in some districts) and, to a lesser extent, in the central provinces. In the northern provinces, however, livestock holding, which traditionally plays an important savings and insurance role in rural Africa, is a very risky activity which many households have decided not to undertake or to do so in reduced scale, primarily due to tsetse fly infestation. In addition, remittances from Mozambican miners in South Africa are a higher source of income in the southern provinces. For example, Save the Children has conducted a survey in Gaza Province which indicates that remittances can account up to 50 percent of household income. However, given the dramatic changes taking place in South Africa, they estimate that this source of income will decline substantially over the next few years. Other sources of income, e.g., small-scale mining (Tete Province) and fishing (along the coastal areas), are only important in specific geographic areas. The overall picture illustrates that, in the present environment, on-farm income represents the most important source of total household income in rural areas. Non-agricultural income generation often plays a key role in facilitating acquisition and use of productivity-enhancing inputs. Non-agricultural income can increase purchased input use or capital investments where credit is unavailable or costly to use, or where other sources of cash in come for loan repayment are lacking. It can also play a role in facilitating conservation investments for which credit is rarely available. Non-agricultural activities also smooth household income and help to reduce risk by diversifying the sources of household income. However, contrary to other African countries where non-agricultural income (particularly trading and small-scale manufacturing) is an important source of rural household income, Mozambique has been devastated by war, a host of natural disasters and inappropriate economic policies. Overall, the low non-agricultural share is understandable, given the effect of rural violence on the willingness and ability to invest in non-farm enterprises. Opportunities for non-agricultural earnings, which take on great importance in the face of land constraints, are currently very limited but should increase as opportunities for commerce and exchange increase with the opening of roads and the restoration of the rural economy.

Public Finances[1]

I. Structure of the Public Sector

The public sector in Mozambique consists of: 1) the central government; 2) eleven provincial governments; 3) local governments; and 4) public enterprises (which are supervised by the ministry responsible for the respective sector). The operations of provincial governments are consolidated with the central government budget. There are only partial data available on local governments and public enterprises.

The central government budget is funded from tax collections, foreign grants and loans, and counterpart funds of foreign grants and loans. Until 1991, there were important extrabudgetary transactions financed by foreign aid, in particular military expenditures for which no information was available. Until 1992, the GRM also issued promissory notes (letras de tesouro) which allowed enterprises to defer payment of counterpart funds. In fact, this practice led to a significant buildup of counterpart fund arrears. These were reactivated in 1994 as the GRM faced an unexpected shortfall in foreign grants of $150 million. The Treasury maintains its accounts at the Bank of Mozambique (BM). Tax collections are deposited into account "number 1" and nonproject foreign grants and loans and their counterparts available to the budget are deposited into account "MB-10."

The fiscal year is the calendar year[2] which covers commitments for both current and investment expenditures from the previous fiscal year. These amounts are shown as part of total expenditures of the following calendar year. The budget was traditionally presented on a cash basis but in 1992 the debt statistics were made consistent with the balance of payments data which allows presentation on a commitments basis.

The central government's expenditures are controlled by a two-step allocation procedure. As a first step, the budget of the current year is presented in prices of the previous year, e.g., the initial version of the budget is calculated in the previous year's prices. Until the budget in constant terms is approved, ministries are allowed to use up to one-sixth of their previous year's budget allocation. Once the budget is adopted, ministries are allowed to utilize up to 70 percent of the current-year allocations in constant prices. This procedure resulted from Mozambique's chronic high inflation which makes current price projections subject to a higher than normal error. Therefore, these projections are not finalized until midyear. For the second step, the budget is recalculated in current prices which includes projected inflation for the second half of the year.

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[1] Trying to understand public finances in Mozambique can be a formidable task. The budget books haven't been closed since 1977 and the last published executed budget was in 1991. Partly to address problems of budget timing, transparency, use as a policy and planning tool, and implementation, USAID proposed in 1994 that a small working group be established among major donors and the government. This group is currently working on the above issues directly with the Ministry of Finance and related ministries.

[2] There is a complementary period through March of the following year.

Ministries are permitted to use up to 90 percent of the current-year allocations in current prices. The remaining 10 percent is kept in reserve for unforeseen expenditures. Unused amounts cannot be carried over to the following year. Although this procedure allows the GRM to avoid involuntary budget overruns, it does not provide a safeguard against shortfalls in foreign aid (which is a perennial problem particularly at the end of the calendar year). When such shortfalls occur, the GRM (in theory if not in practice), has to take compensatory measures to maintain the target for domestic bank borrowing (see the Money and Banking Section).

In recent years, the coverage of the investment budget has improved considerably. In 1990, a rolling public three year investment program (PTIP) was instituted. The PTIP aims at bringing all investment, especially that financed with foreign aid, under the purview of the government budget. Although efforts have been made to properly classify current and investment expenditures, there remains some overlap. This is particularly difficult since donors finance 70 percent of the investment budget (this is exacerbated by the fact that a significant amount of technical assistance is financed under donor projects which incorrectly shows up in investment expenditures). There is a plethora of investment projects by donors which gives the government little control over a huge portion of the investment budget and thereby limits their ability to track activities on the investment side.[3]

II. Performance

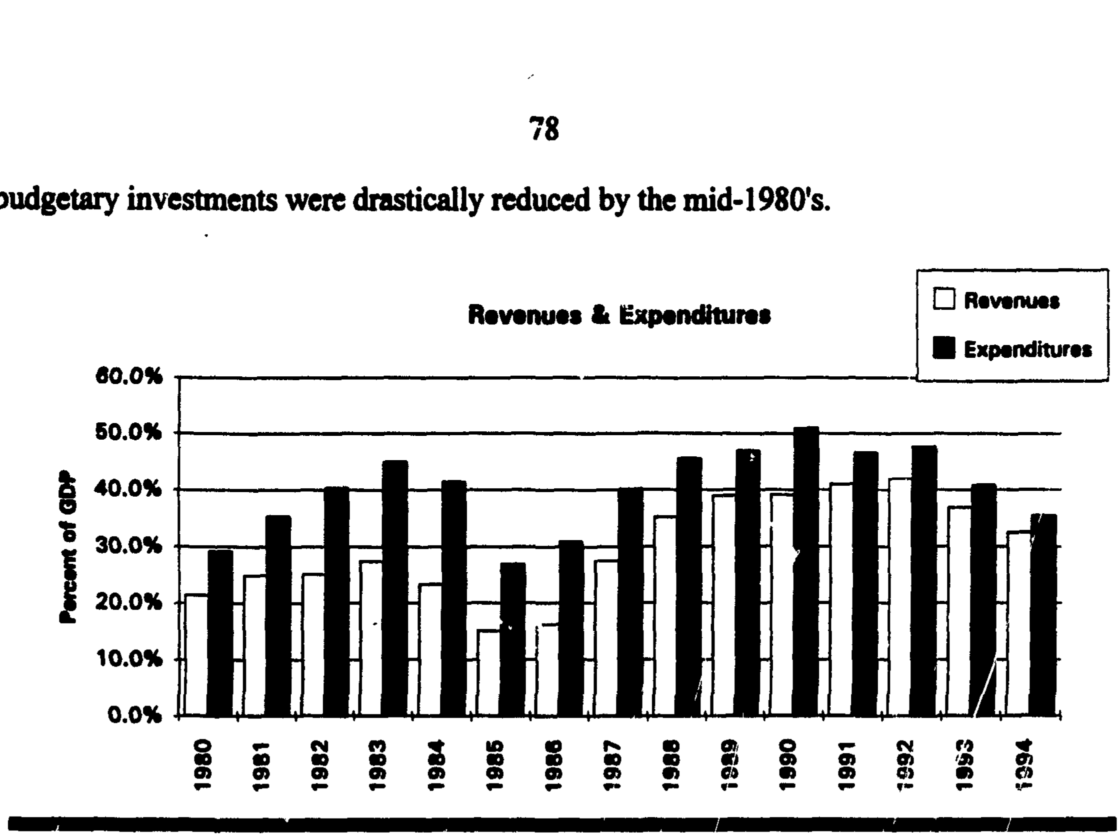
Developments during the early to mid-1980's in government finances (as in overall production and investment) reflected the disruptive effects of sabotage and terrorism in various parts of the country, periodic natural disasters, the heavy burden of defense outlays, distortions due to the prevailing administrative mechanisms and inappropriate policies. Scarcities and unofficial markets became pervasive as real and financial imbalances deepened. Revenues stagnated in the early to mid-1980's as a result of the shrinking tax base. Recurrent expenditures doubled in nominal terms between 1980 and 1986 as a result of a threefold increase in defense outlays which resulted in the disappearance of the current budget surplus. This occurred despite increasingly stringent measures to hold down recurrent expenditures[4].

Bank credit was provided not only for general budgetary support but also to finance mounting enterprise losses caused by physical destruction, shortages of inputs and inflexible pricing. The provision of such subsidies exceeded defense expenditures by 1986. High levels of investment were maintained into the early 1980's, supported by substantial external borrowing. However, production and export levels fell rather than continuing upward as expected and debt service became unmanageable. Loan inflows fell sharply during 1983-1985 and both budgetary and

[3] For example, as of February 1995, the executed investment budget for 1993 was still not available to the budget working group. To address this problem, the donor budget working group has decided with the Ministry of Finance to initiate a new tracking procedure in order for the government to get a better handle on investment expenditures. In addition, the IMF is providing assistance to improve tracking procedures.

[4] Especially those related to goods and services.

extrabudgetary investments were drastically reduced by the mid-1980's.



The comprehensive ERP adopted and implemented in 1987 substantially altered the macroeconomic and fiscal environment in Mozambique. Government fiscal policy under the ERP pursued the following objectives: 1) the progressive elimination of the current account deficit; 2) the limitation of capital (investment) expenditures to that level which could be fully financed from external resources and was economically justifiable in the context of the ERP; and 3) the consequent restriction of domestic bank financing to the GRM. The strategy to address these objectives had the following components: 1) strengthen the revenue base resulting from increased tax buoyancy and efficiency in the administration and collection of taxes; 2) rationalize and restore financial discipline to public enterprises; 3) maintain recurrent expenditures; 4) prioritize capital expenditures; and 5) improve the coordination and utilization of external resources.

The major package of revenue measures introduced at the start of the ERP in 1987, together with considerable reintegration of market and price structures, led to renewed buoyancy in revenues. Total revenues tripled in 1987 and revenue increased as a share of GDP from 13 percent in 1986 to 17 percent in 1987. Recurrent expenditures were contained mainly through the control of wages and salaries and transfer payments. Wages and salaries were held constant in real terms. Explicit transfers to enterprises, which were targeted to be held constant in real terms, actually fell by 30 percent. Consumption subsidies were limited to 4 percent of current expenditure. Through these measures the current budget deficit (excluding grants) as a share of GDP was reduced sharply while the overall deficit increased modestly as a result of the impact of exchange rate changes on investment expenditures. The GRM's recourse to bank credit fell substantially in 1987 and 1988. Budgetary investment expenditures increased significantly in nominal terms, reflecting the exchange rate devaluation and a considerable real increment. External grant and loan receipts more than covered the rise in capital outlays with the result that recourse to domestic bank financing decreased.

The size of the public sector in Mozambique in 1987 was very large. The Central Government accounted for 47 percent of GDP. Total public expenditures, including parastatal contributions, accounted for about 70 percent of GDP. This was a particularly large share taking into account that marketed GDP (the relevant concept from a resource point of view) is estimated to have represented around 60 percent of total GDP. This was a result of several complex political and economic developments: 1) the private sector virtually collapsed after independence for a variety of reasons, including the implementation of central planning and state ownership and the departure of an estimated 90 percent of the skilled labor force; 2) the GRM tried to address several pressing social needs of the population, particularly in health and education, by expanding expenditures in those areas; 3) the GRM spent large amounts on defense and special relief efforts; and 4) the unusually large external assistance (grants and loans exceeded tax revenues) was channelled mainly through the government and focused primarily on investment projects.

Fiscal policy under the recovery program has aimed at rehabilitating economic and social infrastructure while reducing monetary financing of the budget. Emphasis was initially placed on mobilizing domestic and external resources and increasing budgetary investment. These objectives were broadly achieved: budgetary investment rose from 17 percent of GDP in 1987 to 24 percent in 1990; and domestic bank financing of the budget deficit fell from 12 percent in 1986 to less than 1 percent of GDP in 1990. However, the overall result was an increase in the primary fiscal deficit before grants from 22 percent in 1987 to 26 percent in 1990.[5] This trend was corrected in subsequent years, until 1994, due to more rigorous prioritization of public expenditures. This allowed for a decline of the primary fiscal deficit before grants to 20.8 percent of GDP in 1993.

Budget coverage was widened to include previously off-budget items amounting to about 10 percent of GDP. A rolling three-year investment budget was introduced with a concomitant reallocation of investment towards the social sectors, agriculture and transport (away from large-scale capital-intensive projects in agriculture). Recurrent expenditures for the social sectors in real terms increased in 1993 (but did not in 1994). In 1992, the inefficient National Food Distribution System was phased out[6], food subsidies were virtually eliminated and a safety net targeted to a segment of poor urban households (those without earning potential) was established.

The overall result of increased resource mobilization (including aid and counterpart funds) and improved prioritization of expenditures resulted in a substantial turnaround of the primary fiscal deficit, after grants, to 3.9 percent of GDP in 1993. However, Mozambique faced a significant shortfall in the generation of counterpart funds (11 percent of GDP) in 1993, resulting from lower than expected disbursements of foreign aid (difficulties in commercializing food aid also

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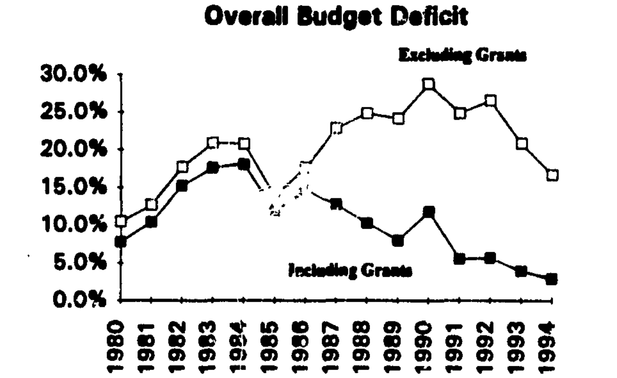
[5] The primary fiscal deficit is used because interest payments were not fully recorded before 1992.

[6] This occurred largely as a result of USAID policy dialogue with the government, based on a series of studies that were conducted in the early 1990's.

contributed to the shortfall). Despite a better than expected performance in the recuperation of counterpart funds and a lower underlying budget deficit before grants , the GRM had to borrow MT 51 billion (0.9 percent of GDP) from the banking system instead of repaying MT 64 billion as programmed. Total revenues declined by two percentage points of GDP (from 21.1 percent of GDP in 1992 to 19 percent of GDP in 1993) as the strong growth of the agricultural sector in 1993 did not result in a pari passu increase in tax and nontax revenues. There were expenditure overruns in some categories, reflecting a larger than projected devaluation of the metical (81 percent against the dollar) and pressures resulting from the negotiations to implement the peace accords. However, the overall budget deficit before grants was lower than programmed.[7] Embedded in the budgetary figures, for the first time, was the establishment of a direct and transparent link between the balance of payments and budgetary debt data, which implied a significant increase in interest payments recorded in the budget compared to 1992. In December 1993, the GRM introduced a partial tax reform aimed at streamlining the tax system and increasing the competitiveness of domestic production and exports.

Current expenditures for 1993 were above the programmed level primarily because of increases in military expenditures which accounted for nearly 40 percent of the budget. The increase in expenditures was partially offset by higher revenues than anticipated. Some shortfalls in loans occurred but were offset by higher than expected grant levels. The shortfall of counterpart funds was even more severe in 1993 than 1992, forcing the GRM to borrow from the banking system which in turn reduced the expected GRM repayment to the banking system.

Fiscal policy in 1994 continued to aim at decreasing the underlying budget deficits (before and after grants, in terms of GDP) as well as reducing the GRM's outstanding debt to the banking system. Although the program envisaged substantial special expenditures related to demobilization and elections, the GRM was expected to repay at least MT 151 billion (2 percent of GDP) to the banking system (compared to the MT 51 billion recourse to the banking system in 1993). Early indications are that this did not happen in 1994, primarily for the same reasons that occurred in 1993. The fiscal deficit, before grants, increased substantially to 30 percent of GDP in 1994 (the target was 25 percent of GDP) and 9 percent, after grants, of GDP. There was a \$150 million shortfall in expected grants in 1994, leading to a marginal increase to a total of \$512 million. Overall, revenues declined and expenditures significantly increased, particularly



[7] These results were partly due to delays in implementation of the peace process which forced the postponement of special expenditures associated with elections and demobilization to 1994. Expenditures with respect to special factors were estimated to be less than 12 percent of the level programmed for 1993.

investment expenditures.

The increase in the 1994 deficit was partly attributable to: 1) the expenditures related to demobilization, elections and the democratization process (5.7 percent of GDP); 2) the decline in government revenues both in real terms and as a percentage of GDP (-2.4 percent); and 3) the rapid increase in budgetary investment (4.3 percent of GDP), which was primarily externally financed. Budgetary allocations to finance the establishment of the Assembly, the operation of political parties and the formation of new electoral and judicial institutions were some of the costs of political reform. In total, expenditures on special factors amounted to 5.7 percent of GDP in 1994. However, other current expenditures (excluding special factors) shrank by close to 16 percent in real terms. Current expenditures on the priority sectors of education and health declined in real terms. The decrease in government revenues contributed to the increase in the deficit in 1994. Budgetary revenues declined as a share of GDP from 20 percent in 1993 to 17.6 percent in 1994. The decline was primarily attributable to the fall in customs revenues and revenues from the consumption tax on imported goods. Poor customs administration and weak enforcement of taxes on international trade were a primary cause of depressed revenues. In addition, the difficulties experienced in the industrial sector were reflected in a decline in the level of industrial imports and therefore in customs revenues.

Net proceeds from the privatization program are targeted to help finance the budget. There has not been much revenue generation to date, given the slow pace of privatization[8]. The GRM's policy has been to minimize subsidies by only providing budgetary transfers to those enterprises that were adversely affected by the war. Explicit enterprise subsidies were targeted not to exceed 0.4 percent of GDP in 1994. However, there is some evidence that significant implicit subsidies to enterprises has occurred as evidenced by increases in other items net in the monetary accounts. Such implicit subsidies are acting as a significant drain on budgetary resources and creating problems in monetary policy (see the Money and Banking section for details). It has been extremely difficult to impose hard budget constraints on public enterprises operating in 'strategic sectors,' because there are so many subtle ways of extending or tolerating indirect fiscal transfers, giving rise to soft budget constraints (negotiable subsidies or taxes, non-payment of dividends or counterpart funds, delinquency on debt service, credit reschedulings, enforceability of suppliers' contracts, fungibility between investment and current expenditures). Regardless of when the inevitable cleanup operation is implemented, significant pressures will be placed on the GRM budget as the unliquidated non-performing assets of public enterprises will have to be transferred from the commercial banks to the treasury. This will obviously place further pressure on an already overstrained budget, especially if the level of donor funding declines to more "normal" levels (Mozambique received $67 per capita in foreign aid in 1993 while the regional average for Souther Africa was $34 per capita).

[8] Although almost 400 small and medium-enterprises have been privatized, only eight large enterprises have been privatized. The privatization process is discussed in the *Business and Regulatory Environment* section.

No simple linear sequencing of reform is possible because so many essential elements are interconnected. In particular, budgetary and monetary control, financial sector reform, and enterprise reform are inseparable as loss-making enterprises put pressure on the budget or undermine the viability of commercial banks through non-repayment of loans. Government efforts to impose a hard budget constraint on state enterprises have been partially successful, but have to some extent also resulted in shifting enterprise losses from the budget to the banking system and to inter-enterprise debt, undermining attempts to create a truly commercial banking system and, in turn, making fiscal and monetary control difficult. It is also difficult to impose hard budget constraints on state enterprises operating in so-called strategic sectors, as there are many subtle ways of extending or tolerating indirect fiscal transfers, giving rise to soft budget constraints (negotiable subsidies or taxes, non-payment of dividends or counterpart funds, delinquency on debt service, credit reschedulings, enforceability of suppliers contracts, and the fungibility between investment and current expenditures). Rapid privatization or closure of many state enterprises becomes complicated because many potentially viable firms are financially distressed due to debts owed by other non-viable enterprises and price distortions. In addition, there are relatively few domestic entrepreneurs and domestic savings are negative so privatization will have to take place with foreign investment. The process of reform in Mozambique is not unlike one of opening up a series of black boxes with respect to information flows, and progressively turning off taps with respect to bringing monetary, fiscal and enterprise accounts under control.

Budgetary allocations are slowly continuing to shift toward priority sectors. Recurrent funds for health and education increased in real terms in 1993 but declined in real terms in 1994 (the end of December inflation rate was 70.8 percent). However, the 1995 budget has significant increases for the social sectors, a real increase of over 40 percent. The coverage of the urban safety net (consisting of cash transfers to identified vulnerable groups) expanded to 60,000 families in 1993. The ratio of the current budget to GDP has declined from 23.1 percent in 1987 to 15.5 percent in 1994 and investment has declined from 24.8 percent in 1987 (after jumping from 7 percent in 1986) to 22.1 percent. The current budget is grossly inadequate to meet minimum maintenance and operating costs. With over half of the current budget accounted for by interest payments on debt (20 percent, primarily external debt) and defense expenditures (41 percent), there is little margin left for financing other recurrent costs. Some progress has been made in improving the management of public investment as the number of projects is being reduced through on-going restructuring. However, the portfolio of projects (about 500) and associated technical assistance remains large in relation to existing absorptive capacity.

The establishment of priorities to channel public and external resources will be extremely difficult, given the size of the needs (see below). In principle, public investment will aim at meeting two objectives (which in the context of scarce resources may conflict with each other): 1) promoting and supporting rural resettlement; and 2) increasing the overall efficiency of private investment, thus reducing the high capital/output ratio, through the rehabilitation of general economic infrastructure.

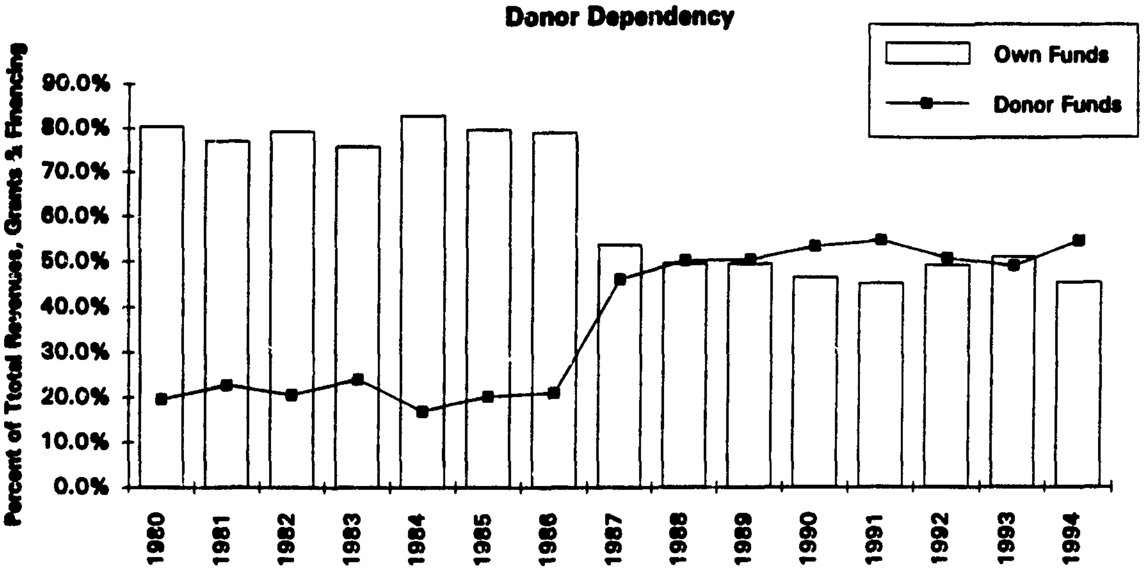
During the 1994-1996 period, an increasing share of public investment will be directed toward the rehabilitation of rural infrastructure. The first phase includes priority projects of the National Reconstruction Plan (described below) designed to respond to the needs of rural communities, especially those involved in resettlement. The pace of rehabilitation of rural infrastructure will depend on the availability of external financing, local construction capacity, trained personnel and recurrent budgetary resources. Because of the imbalance between the recurrent and investment budget, alternative sources of finance will have to come from the community level.

This is particularly relevant as food aid levels decline over time. Food aid generates significant counterpart funds for the budget (as well as balance of payments support). Food aid levels have declined in response to increased domestic production and reduced emergency assistance requirements, with the concomitant decline in counterpart funds which have been essential in financing the GRM's budget. Barring a drought and famine in, food aid levels will continue to decline, in particular, emergency food aid, thus reducing a significant source of funds for the government budget. A change in the composition of aid may eventually allow direct budgetary support but, at present, most donors are reluctant to do this until the budgetary process becomes more transparent and accountable.

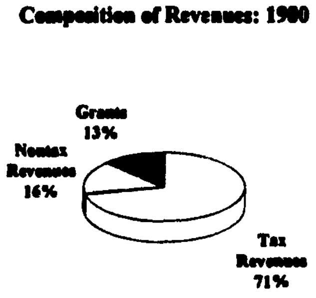
III. Revenues

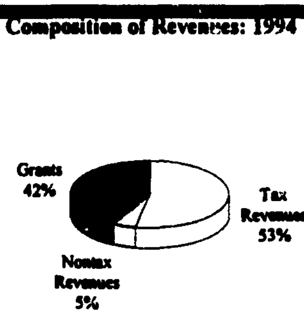
A. Donor Dependency

The execution of the budget in Mozambique is greatly dependent on the availability of foreign aid. Donor funds financed 55 percent of the budget in 1994 and are expected to finance 65 percent in 1995. When disbursements fall short of pledges, the authorities attempt to rein in their expenditures. Counterpart funds (CPF) are used for general current budgetary expenditures. The budget is drawn up based on pledges obtained at the Consultative Group meetings. Because it is so dependent on foreign aid, amounts subsequently not collected hinder the GRM's ability to properly execute the budget. In case of a shortfall, the GRM must take compensatory fiscal measures in order to maintain the target for domestic bank credit. By the same token, unplanned overdue amounts collected in a budget year represent windfalls, allowing the GRM, ceteris paribus, to improve its position with the banking system. However, if the shortfall is toward the end of the year (as frequently occurs), this usually results in higher than expected bank borrowing to cover the shortfall (see the Money and Banking Section). Reflecting this dependency, the GRM is asking donors to pledge $1.5 billion, excluding debt relief, at the eighth Consultative Group meeting in Paris in March 1995.



B. Structure of Revenues





The composition of revenues has shifted dramatically since 1980. Tax revenues declined from 71 percent of total revenue in 1980 to 53 percent by 1994. Nontax revenue declined from 16 percent of total revenue in 1980 to 5 percent in 1994. The shortfall has been made up by foreign grants which increased from 13 percent of total revenue in 1980 to 42 percent in 1994. Revenue grew, relative to GDP, during 1989-1992 because of an increase in the turnover tax base as well as the streamlining of rates regarding international trade and excise taxes. In 1991, the GRM extended the turnover tax rate to imported products while reducing the turnover tax for domestic producers. At the same time, the customs tariff was reduced from 34 rates to 6 rates and excise taxes were simplified, facilitating their collection. These measures had a significant impact on revenues in 1991 and 1992. However, international trade taxes fell

b. Taxes on International Trade

Taxes on international trade include import duties, export taxes[9], and other fees and charges. This category accounted for 31.2 percent of tax revenue and 16.5 percent of total revenue in 1994. Of these, import taxes represented the largest share of total revenue (11.5 percent) and other taxes were 5 percent of total revenue.

c. Taxes on Income and Profits

Taxes on income and profits include a corporate income tax, a personal income tax and a complementary tax. This category accounted for 12.2 percent of tax revenue (31.7 percent in 1980) and 6.5 percent of total revenue in 1994. Of these, the corporate tax represented 2.6 percent of total revenue and the personal income tax represented 3.9 percent. The complementary tax basically dropped off to zero in 1994.

d. Other Taxes

Other taxes include: stamp taxes, poll taxes, property taxes, and other taxes and duties. This category accounted for 2.9 percent of tax revenue and 1.5 percent of total revenue in 1994. Of the above items, the stamp tax is the largest contributor (1.9 percent of total revenue).

C. Major Taxes

1. Taxes on Income and Profits

a. Business Profits Tax (Contribuicao Industrial)

All entities and individuals carrying on commercial and industrial activities are chargeable with tax on net profits and capital gains accrued in Mozambique in the preceding year of assessment ending December 31. Taxable income is from all sources in Mozambique and one third of gross income before taxes received from abroad by a resident company. There are three major categories established for payment (Groups A, B and C). Taxpayers that keep their accounts in accordance with accepted principles of accounting (Group A) file returns in May or June, which are used to determine taxable income. Group A includes: state enterprises; companies and limited partnerships; companies earning profits or having domicile or main offices abroad; resident companies receiving income from abroad; taxpayers whose average turnover in the three preceding years exceeded MT 15 million; and others whose accounts are kept by a certified

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[9] It is difficult to determine the level of export taxes. The Ministry of Finance adamantly stated in late 1994 that there are no export taxes in Mozambique as part of the recent tax reform package which included a five year suspension of the 0.5 percent rate. However, the GRM and the World Bank announced in November 1994 that the 30 percent export tax on unprocessed cashew nuts would eventually be eliminated over a three year period. The budget line item for export taxes is listed as 0 in 1994. In 1993, export taxes were MT 1.6 billion or 0.1 percent of total revenue..

accountant and who are authorized to register in the group. Group B is designated for taxpayers who do not keep regular account: nd file a simplified return in February. Group C covers small businesses of self-employed individuals not falling within the Labor Income Tax, whose average sales or output in the three preceding years did not exceed MT 100,000 monthly. The tax offices are responsible for tax assessment, which for Group B taxpayers depends on prior determination of the tax base by an income determination committee.

Exemptions include: the FRELIMO party; the state and its services; the 'democratic people's organizations'; social security institutions; income of production or services cooperatives subject to the Labor Income Tax; and cultural, recreational, physical education, or sports associations having approved charters. Deductions include (for Group A only); prescribed expenditure (not including payments made to nonresidents unless it can be proven that these payments are essential for the generation of income); expenditure incurred in providing various types of medical and social assistance to employees and their families; taxes excluding the Business Profits Tax; losses from the three previous years; donations up to the equivalent of 8 percent of taxable income in the previous year (grants to the state and the Frelimo Party are fully deductible); and straight-line depreciation allowances established by the Minster of Finance or calculated according to a justifiable method authorized by the Tax Department.

The relevant rates are 50 percent on taxable profits for Groups A and B with a quittance rate of 15 percent withheld at source by the paying entity or enterprise on the gross amount before taxes of any payment to commercial enterprises or entities not showing proof of tax registration. Specific rates for Group C are established by each provincial government by October 31 of the preceding year in amounts that are at least equal to and at most twice those determined by the Ministry of Finance. For example: basket weavers and artisans are charged MT 20,000 in Maputo and Sofala provinces, MT 10,000 in Zambezia and Nampula provinces and MT 10,000 in all other provinces.

The following corporate income tax rates were established under the December 1993 tax reform package.

- Agriculture 35%
- Industry 40%
- Other Sectors 45%.

In addition, one of the measures approved allows for the revaluation of fixed assets as of December 31, 1993. The detailed procedures to be applied in this revaluation are essentially the same as those applied in respect of the previous revaluation in 1988. In some circumstances, the revaluation of fully depreciated assets is permitted as well as the revaluation of assets based on revaluation criteria which differ from the monetary correction norm. The revaluation of assets may be performed as of December 31, 1993 or December 31, 1994.

b. Taxes on Individual Income

i. Labor Income Tax (Imposto sobre os Rendimentos do Trabalho)

The labor income tax is applied under two sections. Section A tax is withheld by employers on salaries and other remuneration paid to citizens and non-citizens, either in cash or in kind. Also taxable are: professional fees, retainers, bonuses, profit-sharing, prizes and similar income; representation and travel allowances; scholarships; remuneration of individual owners or partners that is accounted for as salary; and taxes and legal fees withheld by employers. The tax office assesses the tax owed by workers who render remunerated services to one or more enterprise under retainer or similar arrangements. In this case, the taxpayer files his return in January, has his income determined by the committee by May 31 and pays tax in July.

Section A exemptions include: government employees whose salaries are paid from the state budget; employees of the Frelimo party and the democratic people's organizations; foreign diplomats who are nationals of the country they represent provided there is reciprocity; and tax payers whose monthly basic remuneration is less than the minimum wage set for their occupation. After deduction of the tax, disposable income cannot be less than the exemption ceiling. The following are deducted from the Section A tax base: retirement and disability pensions; expense allowances, up to the ceiling established for employees of the state earning equivalent remunerations; family and separation allowances; wages of occasional farm workers and household servants; and income subject to the complementary tax at the quittance rate of 30 percent.

The marginal rates for Section A are 6 percent for monthly income up to MT 30,000 and 15 percent for over MT 15,000 per month. Other income such as occasional income of wage earners, honoraria received by partners and owners, and payments for services rendered have a marginal tax rate of 15 percent.

Section B tax is imposed on presumptive income of production and service cooperatives and of individuals carrying on agricultural, forestry, and livestock operations exceeding size and development criteria established by the Minister of Finance in consultation with the Minister of Agriculture. These criteria refer to the size of the cultivated area, the use of tractors, and the number of employees hired according to the activity. The tax is assessed by the tax office and paid in up to four quarterly installments. Section B provides for temporary exemption of taxpayers who are unable to meet tax obligations because of natural disasters. Exemption is granted by the Minister of Finance upon proposal of provincial governments.

Section B tax rates vary from 1 percent to 30 percent, according to the province, culture, location, and exploitation regime. They are established annually by the Minster of Finance, in consultation with the provincial governments. Generally, the rate is about 4 percent.

ii. Complementary Tax (Imposto Complementar)

The complementary tax is a progressive surtax levied annually on: overall individual income accrued in or derived from Mozambique and abroad, received by a resident, and income received by nonresidents from Mozambican sources; and capital income generated in Mozambique, even if the payee cannot be individually identified or if earned by corporations. The sum of labor income, profits from commercial and industrial activities, and capital income is taxable. Taxpayers are assessed on aggregate household income. In the case of a company subject to the Business Profits Tax (Group B), the complementary tax is chargeable on the difference between taxable profits, net of the corresponding tax, and the declared distribution of earnings. Payment is made in November. Labor income earners are subject to withholding at source of the complementary tax on the excess of their yearly income (grossed up by income of other household members, if any, and net of the labor income tax under Section A) over the applicable personal allowance. Also subject to withholding at source are: capital income paid to legal entities (18 percent); profits attributed to partners (18 percent); amounts paid as professional fees, retainers, bonuses, and similar income (5 percent); artists' remuneration (5 percent); and capital income other than the above (5 percent).

Exempted are: labor income of any kind paid to state employees and to employees of the Frelimo party and the democratic people's organizations (this income is not included for the purpose of determining the rate of tax on the taxpayer's other income); salaries of foreign diplomats who are nationals of the country they represent, provided there is reciprocity; income of farmers subject to the labor income tax (Section B); income of taxpayers subject to the business profits tax (Group C); interest on treasury bills and government securities (issued in the late 1980's); and interest on demand and time deposits with domestic banks. The following personal allowances are deductible from earned income: MT 600,000 for widowed, single or divorced taxpayers; MT 600,000 for wives; and MT 400,000 for household. Other deductions from income are: business profits tax and labor income tax levied on aggregate income; obligatory employee contributions; and donations to the state and Frelimo party.

As part of the December 1993 reform package, personal income taxes were adjusted, effective January 1, 1994. The marginal tax rates on taxable annual income are

Monthly remuneration

Amount up to 99,999 Meticais	Exempt
100,000 Mt - 125,000 Mt	6%
125,001 Mt - 600,000 Mt	15%
Over 600,000 Mt	15%

Other earnings, freelance earnings and fixed-term employment earnings (avencas) will be subject to taxation at a flat rate of 30 percent, regardless of the amounts involved. Also, under the December 1993 reform, salaries and wages will no longer be subject to this tax and profits realized on the transmission of share or quota holdings are now subject to this tax.

c. Taxes on Goods and Services

i. Turnover Tax

The turnover tax is an ad valorem cascading tax levied on domestic transactions (sales of goods and services) of enterprises that carry on activities subject to the business profits tax. Also subject to the turnover tax on their budgetary receipts are government services enjoying administrative and financial autonomy. The tax base of imported goods includes customs duties and customs fees. The tax base excludes the consumption tax, except at the retail stage. Where turnover declared by taxpayers is lower than would result from the use of market or normal prices, the base for calculating the tax liability may be adjusted annually by the income determination committee referred to above. The tax must be paid by the end of the month following the month of sales.

Exemptions include: sales by production and service cooperatives and individual farmers subject to the labor income tax (Section B); sales by small businesses or self-employed individuals (Group C taxpayers under the business profits tax); receipts from printing and sale of newspapers; sales by workers' canteens, student cafeterias or hospitals for immediate consumption; sale of stamps and stamped paper; mining enterprises as defined by law; sale and resale of bread by consumers' cooperatives; exports; importers' sales of kerosene; retail sales of processed tobacco; and oil imports.

The relevant rates are: 1 percent for sales of oil products by distributors and retailers; 3 percent for sales of farm products by rural marketing agents located in rural areas; 5 percent on imports, producers and wholesalers, and government services; 10 percent on sales of oil products to PETROMOC and retailers and services; and 20 percent for telecommunications, hotel and tourist services. When wholesale and retail functions are combined, the 10 percent rate applies, unless otherwise determined by the Ministry of Finance. The Minister of Finance may establish, in consultation with the Minister of Commerce, selective rates between 5 and 20 percent, to apply to particular transactions or activities whenever priorities of economic policy or peculiarities of price formation mechanisms so dictate.

Under the December 1993 reform, an exemption on the payment of this tax was introduced for raw materials and finished products (whether imported or not) when such items are to be used as inputs to production by national industries. This exemption will be applied through a requisition system similar to that in place for the Consumption Tax exemption. This should greatly facilitate its implementation. However, certain difficulties in the implementation of this exemption mechanism will arise, because of the following factors:

- The Consumption Tax is only applied once. The Circulation Tax, however, is a cascading tax. Therefore, in the case of production inputs which are not directly procured by producers (or in the case of importers not effected directly by the producer), it is not clear whether exemptions will be possible.

- The Consumption Tax covers only a limited number of commodities. The

> Circulation Tax is applied to all transactions in the country. This means that a large number of applications for exemption will be made which will probably result in operational delays and difficulties in granting exemptions.

There is further confusion because these amendments appear to refer only to 'Industry' which is not clearly defined.

ii. Consumption Tax (Imposto de Consumo)

The consumption tax is a tax on consumption of locally-produced and imported goods included in specific lists with the same nomenclature as the customs tariff. The tax is collected either from the domestic manufacturer or the importer on a single occasion. Taxable events are the sale of goods by their producers, the importation of goods for final use, the consumption or sale by manufacturers of goods intended for use as raw materials or intermediate products, and the consumption of finished products by their producers. The tax is levied on the ex-factory gross price without deductions or, in the case of imports, on the customs value plus customs duties and fees. Where the transaction value on the basis of which the tax was assessed is lower than the usual or normal ex-factory price, adjustments may be made by the income determination committee. The tax must be paid by the 20th of the month following the month of sales. When collected from the manufacturer, the tax is paid by the end of the month following the month of sales. When collected at customs, it is paid together with the import duties.

Exemptions include: producers' equipment and tools; imported or domestically-produced raw materials and intermediate goods for further processing by domestic industries; exports; handicrafts; upon decision by the MOF, domestically-produced goods intended for use by the Army or donated to the state, and imported goods, if so stipulated in contracts to which the state is a party; and oil products.

All taxes are ad valorem. The 10, 20 and 30 percent rates apply to most procedures but 45, 50, 70, 75, 100, 130, and 150 percent rates also apply. The 20 percent rate is applied to most food items, wax products, edible oils, photographic film, plastics, leather products (except cigarette cases and tobacco pouches), wooden products, most paper products, bathtubs and washbasins, and most products in iron, steel and aluminum. Textiles are subject to the 30 percent rate. Toys, games, watches, and washers and dryers are subject to the 45 percent rate. Alcoholic beverages (excluding beer), perfumes, eyeglasses, jewelry and motorcycles are subject to the 75 percent rate. Cigarettes are subject to the 150 percent rate. Domestic beer is subject to the 130 percent rate and imported beer is subject to the 75 percent rate. Automobiles are subject to the 20 percent rate (up to 20 million meticais), 50 percent (valued between 20-40 million meticais) and 100 percent (over 40 million meticais).

iii. Special Tax on Fuels (Imposto Especial sobre Combustiveis)

This tax is levied on all domestically produced or imported fuels intended for domestic consumption. Taxable are: refiners and importers producing or marketing fuel; and individual importers or fuel for their own or others' consumption. Proceeds go to the central budget, except for MT 250 and MT 300 per liter of regular and premium gasoline, respectively, which go to the Road Maintenance Fund.

Application of the tax to kerosene, diesel, fuel oil and liquified petroleum gas (LEG) has been suspended. The rates are subject to adjustment by the Minister of Finance as necessary.

d. Taxes on International Trade

i. Taxes on Imports

Customs duties (Direitos de Importacao)

Customs duties are levied on all imports according to the tariff (pauta dos direitos de importacao), unless exempt by special provision. Ad valorem duties are based on c.i.f. value of imports, determined according to the Brussels Definition of Value. About half the tariff is subject to specific taxes.

Exemptions include: imports for diplomatic services, travelers' baggage, works of art, imports with no commercial value, and other traditionally-exempted imports; imports associated with external grants and externally-financed projects; capital goods imported under the investment incentives law; oil products; and exemptions authorized by the Minster of Finance.

Most consumer goods are taxed in the range of 5-25 percent. Some textiles and luxury items as well as unprocessed foodstuffs are taxed at 35 percent. Raw materials and intermediate goods are taxed in the range of 1-30 percent. Most machinery is taxed at 5 percent. Other capital goods are taxed in the range of 5-35 percent.

Under the December 1993 reform, customs duties on raw material inputs to production were reduced to 5 percent. Also under the December 1993 reform, in the case of imported goods, circulation and consumption taxes will be levied on the 'customs value', normally the CIF price. These taxes will no longer be levied, as has been the case since the introduction of the current customs tariffs, on the customs value - CIF plus customs duties and handling fees (emolumentos gerais aduaneiros).

Customs Fee (Emolumentos Gerais Aduaneiros)

The customs fee is a fiscal duty levied on the c.i.f. value of all imports. Imports belonging to the first category of exemptions listed under customs duties are exempt from the customs fee. The rate was 7.5 percent. Under the December 1993 reform, customs handling fees (Emolumentos Gerais Aduaneiros) were reduced to 5 percent. It has recently been reduced to 2.5 percent.

ii. Taxes on Exports

Export Duties (Direitos de Exportacao)

Export duties are levied on all exports. Exemptions include: baggage, including automobiles imported without drawing on the foreign exchange fund; goods purchased in duty-free shops; merchandise for exhibitions; and other items form Schedule IX of the tariff. Deductions from the customs value include: freight and insurance costs; customs duties and taxes; and shipping costs or a percentage, as determined by the Minister of Finance. The rate is 0.5 percent but has been suspended under the December 1993 tax reform for five years..

e. Other

i. Poll Tax

The poll tax is a head tax levied annually on all citizens and resident foreigners who earn income taxable under the labor income tax (Section A), the business profits tax, or the complementary tax, on all male residents between 18 and 60 years of age. The proceeds of the tax are allocated as follows: 5 percent to officials in charge of taxpayers' census and tax assessment; 70 percent to provincial budgets; and 25 percent to district budgets.

Exempted from the tax are: full-time students in the national education system, until 25 years of age if attending college; persons incapacitated for work because of sickness or physical malformation; male citizens while in the military service; pensioners receiving no income other than their pensions; and diplomats. The code provides for temporary exemption of taxpayers who are unable to meet the tax obligation because of natural disasters; exemption is granted by the Minister of Finance upon proposal of provincial governments.

The rates are: MT 2000 for Maputo city and Maputo Province; MT 1500 for the city of Beira and provinces of Gaza, Inhambane, Nampula, Niassa and Tete; and MT 1000 for the provinces of Sofala (excluding Beira), Manica, Zambezia and Cabo Delgado.

ii. Stamp Tax

There is a requirement that stamps be affixed to: official papers, accounting and register books, and documents such as those used for import and export purposes; receipts; tickets; contracts; bills of exchange; bonds; sales of some products such as lottery and sports tickets; and many licenses and permits. There is also obligatory use of special stamped paper for a variety of legal documents. In many cases stamp taxes are the equivalent of sales tax on goods and services, particularly those subject to ad valorem rates. A variety of documents and papers, mostly those issued by the GRM, are exempted. Various rates apply on different documents. Examples of ad valorem rates are: 0.1 percent on credit operations; 0.4 percent on equity operations; 0.7 percent on import and export operations; 2 percent on maritime insurance policies. Most rates are specific, e.g.: MT 275 on hunting licenses and MT 1500 on school diplomas.

iii. Tourism Tax

The tourism tax is levied on the value of hotel and tourism services. There are no exemptions or deductions. The rate is 3 percent.

iv. Motor Vehicle Tax (Imposto de Compensacao)

This tax is levied on ownership of motor vehicles not subject to the gasoline taxes. Exempted are: the State and Executive Councils; foreign states, when there is reciprocity of treatment; personnel of diplomatic and consular missions; farm tractors; and vehicles for driving instruction, for sale, seized, or unused for more than three months. The rate is MT 30,000 for light vehicles and MT 24,000 for heavy vehicles.

Other taxes remain in effect but their importance decreased sharply because of nationalization of land and urban property. They are: tax on rental income (contribuicao predial), levied annually on the actual or presumed rental value of urban property; the gift and inheritance tax (imposto sobre as successoes e doacoes), formerly chargeable to the beneficiary; and a tax on transfers of real property (sisa). Some minor duties have been maintained in the customs legislation, despite the tariff reform of 1991. In addition to the stamp tax, the following also apply: to imports, consumption tax and broadcasting fee; to exports, the value-added tax; and to both imports and exports, the warehousing fee and the maritime trade tax (based on weight). Although not included in the current customs legislation, two very minor taxes are also collected by Customs: the lighthouse tax (imposto de farolagem) and the tonnage tax (imposto de tonelagem).

D. Tax Reform

An IMF/FAD mission visited Mozambique in April 1993 to study the tax system and recommended a number of measures to broaden the tax base and reduce significant distortions. The study's recommendations included: 1) replacement of the turnover, consumption and tourism taxes by a value-added tax (VAT); 2) strengthening customs administration; 3) improving the assessment of income and profit taxes; 4) review the system of import tariff exemptions; and 5) computerize the tax administration office. In December, 1993 the GRM implemented a number of these recommendations. The tax reform package included: eliminating of the turnover (consumption) tax on imported inputs; reducing tariffs on inputs to 5 percent (it was later reduced to 2.5 percent); reducing the industrial contribution tax; and updating nominal values and fines used in tax regulations, new rules for the revaluation of fixed assets and the rationalization of the structure of consumption taxes. The GRM is currently considering the introduction of a simplified value-added tax. The above mission also recommended adopting measures to improve customs administration in order to reduce smuggling and to process imports more efficiently (primarily by improving border controls and the processing of goods leaving bonded warehouses).

In general, tax penalties and fines have been raised to take into account the depreciation of the metical. This appears to have been the principal criteria in effecting these increases. An important new measure which has been introduced in relation to fiscal infractions is the possible application of punitive penalties, e.g., temporary or permanent suspension of business activities, publication of the sentence and the loss or suspension of fiscal benefits or ineligibility of such benefits. However, such punitive penalties will only be applied where repeated conviction for tax fraud has taken place.

The Mozambican business community has been increasingly vocal in calling for tax and customs reform as the current structure is prohibiting them from being competitive (see the Business and Investment Climate section for details). Many local producers face negative effective protection in the domestic market. This results from the inability of Customs to control and enforce duty payments on competing imports while authorities seem more successful at collecting duties on inputs imported by manufacturers as well as the consumption tax and turnover tax on final output. This uneven tax collection performance is partly explained by the fact that formal sector firms are easier targets for tax authorities, particularly concerning the consumption and turnover tax which are collected at the ex-factory gate level. Registered companies in Mozambique are obliged to pay a number of direct (corporate tax, payroll tax,) and indirect taxes (consumption tax, turnover tax, import duties, etc.) plus assorted stamp duties associated with specific transactions. While progress has been made in rationalizing the tax regime through reductions in the level and number of tax rates, the tax burden in Mozambique remains quite heavy and constitutes a strong incentive for informal sector activities, particularly for import smuggling. Massive tax evasion has occurred because of the cascading nature of the tax system and the associated ad hoc requirements.

Leakages through Customs are particularly egregious. A recent World Bank study did a rough comparison between the revenue collected by Customs in 1993 against what should have been collected if statutory duties had been charged on recorded imports. The analysis revealed a shortfall of 55 percent. About one-third of the shortfall ($27 million) was accounted for by official exemptions granted under various exemption programs (donor-financed projects, diplomatic cargo and the investment code) while the remaining gap ($60 million) reflects tax evasion. However, this gap probably underestimates the shortfall because it excludes the effect of underinvoicing of imports, which is a major source of tax evasion, and because it is based on the value of imports which was reported by Customs ($598.8 million), which is well below the value of imports estimated for the balance of payments ($878 million, excluding emergency aid). The effective domestic tax burden on industry is proportionally much higher than that on imports: the value of the turnover tax collected from industry was comparable to that collected on imports ($17 million and $20 million, respectively), despite the fact that industrial output is less than half the level of imports. Finally, price comparisons between imported and locally produced goods sold in the local market confirms that many imported goods, mostly consumer goods, are actually entering the country duty-free[10].

According to the latest tax package adopted in December 1993 (described above), the corporate tax in Mozambique has been reduced from 50 percent to 35-45 percent, depending on the type of economic activity. Provisions have also been made to reduce import duties on raw materials and to exempt industrial inputs from the turnover tax. However, overall indirect taxation on finished products is still high, particularly for consumer goods imports. While the level of import duty alone is not unreasonable at 35 percent, the total import tax on consumer goods amounts to a minimum of 65 percent when other taxes are included.[11] In addition, any move through the distribution chain would add a further 10 percent to the sale price. Because of the payment of duties and import charges, the cost of imported inputs has been estimated at 16 to 33 percent above world market prices for many exports. As a result, the manufacturing cost for these products is estimated at 10-22 percent over world prices. For an economy with a very low purchasing power and highly dependent on imports, this level of taxation is certainly too high.

Producers for the local market are therefore faced with high levels of negative protection, ranging from 35 percent to 439 percent. While a situation persists in which domestic industries pay taxes on their inputs and output, and importers of competing goods enjoy de facto tax-free status, it will not be surprising if domestic industry continues to atrophy.

Many of the taxes in the current structure are mainly nuisance taxes, e.g., the turnover tax and the stamp tax. Special forms for the turnover tax must be submitted monthly in five copies for each sale and product unit. Even minor transactions require stamp taxes. While the monetary cost of the stamp tax is modest (MT 100 each), compliance costs are high as they involve time and resources for both the private and government agents. A more serious problem results from the methods used to calculate the stamp duty liabilities for specific transactions, e.g., stamp duties payable for notarization of collateral in credit transactions can be high as 7 percent of the value of the asset.

The high level of indirect taxation creates incentives for negotiation of ad hoc exemptions with the Ministry of Finance. This is also the case of many tax exemptions/deductions provided under the tax law (see above for details). Even in the case of tax breaks provided under the investment code, companies must undertake additional paperwork to make the benefits effective, despite the fact that the investment registration at the Ministry of Finance already indicates eligibility. In addition, the high level of exemptions and deductions is heavily tilted toward state workers and the Frelimo party and related organizations, a practice that is no longer relevant after democratic elections were held last October.

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[10] The price of imported beer is a good example. Beer imported from South Africa is actually cheaper in Maputo, in spite of protective measures described above, than it is in South Africa (after the application of the 14 percent VAT in South Africa). The local beer industry cannot compete and there are chronic shortages of locally produced beer.

[11] Including a minimum consumption tax (20 percent), a turnover tax (5 percent), and a customs handling fee (5 percent).

In order to address the above problems, the GRM announced the following measures to be undertaken in 1995: 1) strengthen the Customs Department through training customs officers, investing in the rehabilitation and expansion of the infrastructure of the main border posts, revising customs legislation to harmonize it with current fiscal and commercial policies, adopting a code of conduct for customs officers and appropriate incentives for customs officers, and implementing the ASYCUDA computerized system; 2) improving the collection of taxes on imports through establishing a new contract with a private firm to provide pre-shipment inspection, control discretionary exemptions and assist the GRM in the management of customs; and 3) modify the system of fiscal taxes to eliminate double taxation and increase efficiency in the collection of taxes.

IV. Expenditures[12]

A. Current Expenditures

1. Structure of Current Expenditures

Current expenditures accounted for 20 percent of GDP in 1993, 17.6 in 1994 and will be 21 percent of GDP in 1995. The graph below illustrates the changes in the composition of current expenditures from 1980. In 1980, defense and security expenditures, salaries and wages, and goods and services were the major components of current expenditures. In 1994, the same three components were the largest but interest on public debt was also substantial, particularly external debt. Salaries and wages plummeted in the mid-1980's as subsidies and transfers and defense and security expenditures increased dramatically. Salaries and wages accounted for 46.2 percent of current expenditures in 1994 (compared to 52 percent in 1993). Goods and services accounted for 53.8 percent of current expenditures in 1994 (compared to 48 percent in 1993). Defense and security expenditures accounted for 41.4 percent of current expenditures in 1994 (compared to 37.4 percent in 1993). The GRM announced in 1995 that current expenditures will be redirected to closely support the country's development priorities. These priorities are reflected in the 1994 budget with: 1) the separation of the defense function from those related to the enforcement of internal security; and 2) the restructuring of current budgetary expenditures towards better governance (customs administration, police and justice), the consolidation of democracy (the Assembly and political parties represented at the Assembly), the social sectors and away from military expenditures. In addition to restructuring budgetary expenditures, the GRM is stressing the need to improve transparency concerning the allocation of budgetary expenditures and strengthen the control of the execution of the budget.

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[12] Figures after 1991 are not comparable to earlier years because of the inclusion of interest payments that were previously settled outside the budget the Bank of Mozambique.

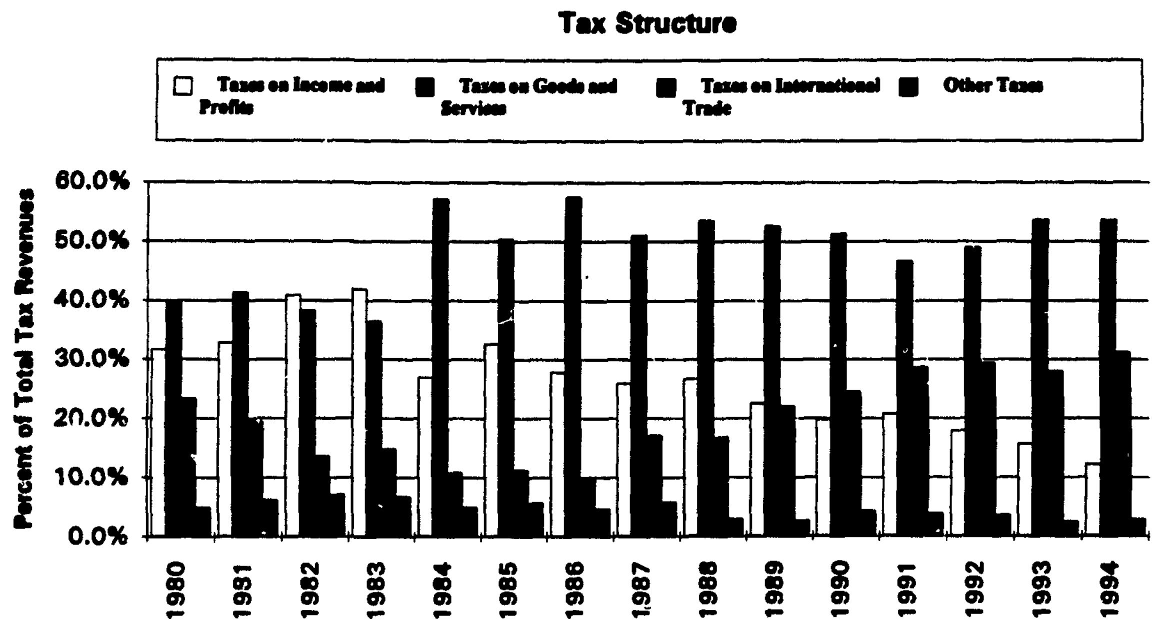
largely because of the drought which shifted imports into categories that were tax exempt (the GRM exempted cereals from import taxes between May 1992 and May 1993). Nontax revenue represented only 4.8 percent of total revenue in 1994 (compared to 24 percent in 1986). The most important components of non-tax revenue are rents and social security contributions.

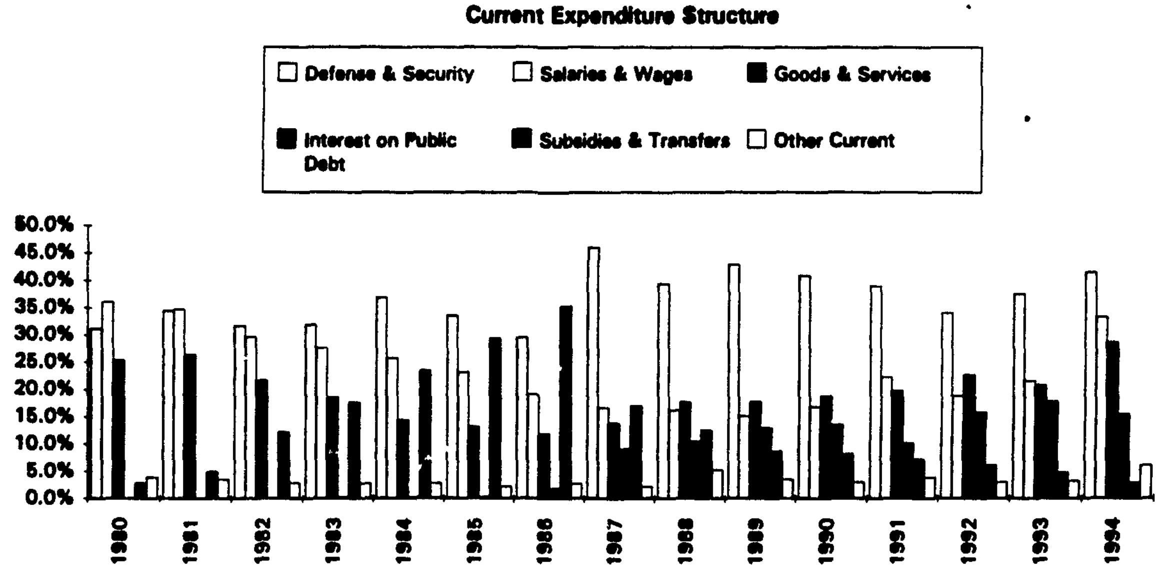
1. Structure of Taxes

The largest group of taxes is that on goods and services, followed by taxes on international trade, taxes on income and profits and other taxes (stamp taxes, poll taxes, property taxes, and other taxes and duties). A detailed overview of major taxes is included below.

a. Taxes on Goods and Services

Taxes on goods and services include: a turnover tax; a petroleum tax; and various consumption taxes - tobacco, beer and soft drinks, textiles, clothing and shoes; other domestic products; and imported products. This category accounted for 53.7 percent of tax revenue and 28.4 percent of total revenue in 1994. Of the above taxes, the turnover tax represents the largest share of total revenue, almost double that of all consumption taxes and 4 times the petroleum tax.





a. Defense and Security

As noted in the above graph, defense and security expenditures have always been the top priority of the government, particularly, of course, during the war. The biggest component of current expenditure in 1994 is defense and security which accounted for 41.4 percent (this includes the portion of defense and security expenditures allocated to the provinces as well as the special funds used for the demobilization process which is why the graph below differs from the overall figure), an 11 percent increase from 1993. This occurred despite the fact that the 1993 budgetary numbers were based on an army of 110,000 soldiers. The official budget numbers for the new army in 1994 (and 1995) were based on an army of 30,000 soldiers, although the new army only consists of 11,500 soldiers[13]. Mozambique's *current expenditures* on defense and security represented 7.6 percent of GDP in 1993 (and an estimated 6.4 percent of GDP in 1994) compared to the Southern Africa regional average ratio of total military expenditures to GDP of only 3.7 percent[14]. Under the 1995 programmed budget, the GRM is planning to reduce military expenditures by 36.7 percent in real terms. Despite an increase in expenditures for strengthening the police force, total security related expenditures (excluding special factors) will decline by 14.6 percent in real terms.

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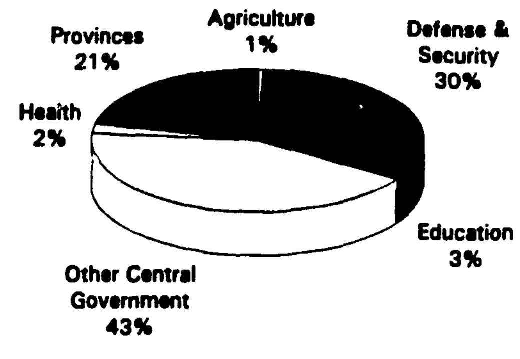
[13] Some sources put the total at considerably less than this. The new army has had considerable difficulty in recruiting, part of which is due to terrible conditions, low salaries and a general war fatigue.

[14] This is based on the latest available data. The regional average excludes Mozambique and Angola.

Composition of Current Expenditures
By Government Sector: 1994



b. Social Sectors

Health expenditures only accounted for 2 percent of the current budget, excluding provincial expenditures, in 1994, reflecting its relatively low priority. Overall health expenditures, including provincial expenditures, accounted for 5.7 percent of total expenditures. Health expenditures increased 24.8 percent in 1994 in nominal terms. Education expenditures only accounted for 3 percent of current expenditures, excluding provincial expenditures, increasing only 30.7 percent in nominal terms[15]. Education expenditures, including provincial expenditures, accounted for 11.5 percent of total expenditures in 1994. The GRM announced a major reorientation of current expenditures in 1995 with a real increase of over 40 percent in health and education combined. Health and education combined will increase their share of total current expenditures to 22.4 percent in 1995. The 1995 budget envisions real increases in education salaries of 39 percent and goods and services of 69 percent. In the health sector, the real increase in salaries is 22 percent and 63 percent in goods and services.

Within the health sector in 1994, the central government receives 37.8 percent of current expenditures allocated to the health sector while provinces receive 62.2 percent. Within the provincial share, the city of Maputo receives 9.9 percent, Nampula province (the most populated province) receives 10.4 percent and Zambezia (the second most populated province and a Rename stronghold) receives only 5.7 percent (Sofala province, which is less populated but a Frelimo stronghold, receives 8.8 percent of the total). Donors fund about 65 percent of current expenditures in the health sector.

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[15] *The rates of increase for the social sectors thereby violates the conditionality of the World Bank's Second Economic Recovery Credit* which stipulated that recurrent costs for the social sectors should be maintained in real terms in 1994. Because of the overlap of some current and investment expenditures, the GRM may be able to increase the amounts, but it is unlikely that they will be able to increase to the level required by inflation, which was roughly 60 percent in 1994.

The health objectives of the GRM Under the 1995 budget, the health sector will recruit close to 750 health technicians (primary and secondary level) recently trained by the university. This will imply an increase in salary expenditures close to MT 2.5 billion (without taking into account the likely increases resulting from promotion, overtime, etc.).

Within the education sector, expenditures have been heavily tilted toward tertiary education (about 18 percent of the total). The University of Edouardo Mondlane's share of current expenditures is twice that of the entire central budget of the Ministry of Education. Current expenditures for the university increased 42 percent from 1993 to 1994 while expenditures for the Ministry of Education only increased 29 percent. The central government receives 31.8 percent of current expenditures for education while the provinces receive 68.2 percent. Within the provincial share, the city of Maputo receives 13.1 percent and Nampula province receives 10.1 percent of the provincial total. Zambezia province, the second most populated province, receives 8.8 percent of the provincial total.

The medium-term objective of the five year government education plan is to build over 7,500 classrooms and to recruit over 12,500 teachers for the primary level. Within that goal, the GRM expects to build 1,500 classrooms and to hire 6,500 teachers in 1995. To achieve that objective, the GRM will implement the following measures in 1995: 1) increase the current budgetary expenditures for education by 44 percent in real terms; 2) open the education sector to private initiatives and develop the integration of private schools within the national education system; and 3) improve the working conditions and salaries of teachers.

The identified financing requirements for social sector current expenditures for the period 1993-2003 were identified under the ongoing Social Sector Public Expenditure Review. In the health sector, the financing gap is projected to be more than $20-24 million per year. In the education sector, the additional financing requirements are estimated to be from $1-3 million per year until 1997, whereafter surpluses are projected between $3.5-6 million dollars per year. The two sectors combined were estimated to require $22 million per year in additional financing in order to meet the current expenditure requirements.[16]

B. Investment Expenditures[17]

1. Structure of Investment Expenditures

Investment expenditures accounted for 20.1 percent of GDP in 1993, 24.4 percent in 1994 and

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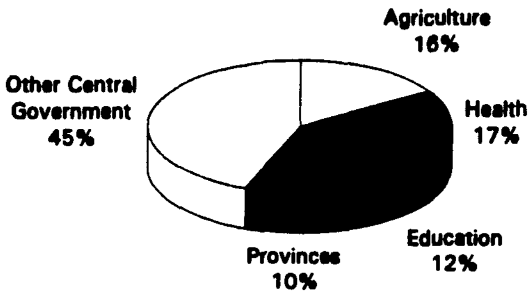
[16] These estimates are currently (February 1995) being revised, significantly upward.

[17] Investment expenditures are, in fact, not really capital expenditures. Since donors finance 70 percent of the investment budget, the budget tends to be composed of a series of donor projects, which include substantial recurrent costs associated with technical assistance, etc. The GRM/donor budget working group is currently working on trying to sort all of this out. The IMF is also trying to address the problem. Because of the nature of the investment budget, the GRM has a particularly difficult time in terms of fiscal policy because the investment budget is a major component over which they have virtually no control.

will be 22.8 percent of GDP in 1995. In 1994, health received 16 percent of total investment expenditures. Education received 12 percent and agriculture received 16 percent. Construction and water received the largest share at 19 percent of total investment expenditures. Donors finance 70 percent of the total investment budget, over 90 percent of the health investment budget and 71 percent of the education investment budget.

Composition of Investment Expenditures
By Government Sector: 1994



2. The Triennial Public Investment Plan (PTIP)

The PTIP process adopted in 1990 represented a major improvement over previous practice, allowing a more efficient programming of investment expenditures. Most projects are executed with foreign aid, both grants and loans. Total investment is concentrated in transport, agriculture and construction. The PTIP has been the main instrument for the prioritization of public investment since 1990. The preparation of the PTIP has typically been based on a sectoral approach with little provincial involvement. The National Reconstruction Program (PRN), described below, aims at filling this gap by providing a framework to incorporate the provincial and local levels into the planning process.

3. National Reconstruction Program (PRN)

The GRM established the medium-term PRN in 1993 to streamline the resettlement process of displaced persons, support reconstruction and to address the implementation of interlinking projects. The planning exercise, which began in 1992, was the first attempt at decentralizing planning in Mozambique. The most important output of this process was the National Reconstruction Plans presented by each province. The PRN consolidates the provincial plans within the framework of national priorities and sectoral strategies.

Another of the major outputs of the planning process was a diagnosis of the current situation of key social and economic infrastructure. The following table illustrates the extent of damage to social and economic infrastructure. Almost 40 percent of infrastructure identified was either destroyed or became non-operational (including due to lack of maintenance from diminishing resources or shifting priorities). Every district was affected. All social and economic infrastructure were destroyed in some cases. In much of the country, the only infrastructure that was not destroyed was that of district capitals.

Infrastructure by Sector	Number of Units				Degree of Destruction (%)	% Non-operational or Destroyed
	Operational	Non-operational	Destroyed	Total		
Agriculture						
Irrigation Systems	118	24	7	149	5	21
Dams	122	208	57	387	15	68
Seed Centers	13	9	0	22	0	41
Nurseries	38	19	4	61	7	38
Dipping Tanks	70	299	40	509	8	67
Water Supply						
Wells	3057	1071	138	4266	3	28
Boreholes	1225	530	32	1787	2	31
Standpipes	484	205	11	700	2	31
Small Systems	96	84	29	209	14	54
Commerce						
Shops and Stores	6664	1318	2381	10363	23	36
Warehouses	369	8	40	417	10	12
Banks	144	6	4	154	3	6
Savings Posts	54	31	0	85	0	36
Communications						
Post Offices	123	8	17	148	11	17
Rural Post Offices	49	90	13	152	9	68
Public Administration						
District Offices	117	33	42	192	22	39
Administrative Post Offices	99	83	120	302	40	67
Residences	724	474	374	1572	24	54
Education						
Primary Schools (EP1)	3051	473	2219	5743	39	47
Primary Schools (EP2)	174	14	11	199	6	13
Secondary Schools	43	1	2	46	4	7
Technical Schools	25	9	1	35	3	29
Health						
Health Posts	643	210	146	999	15	36

Health Centers	220	40	17	277	6	21
Rural Hospitals	21	0	1	22	3	5

Exacerbating the destruction of infrastructure, of course, was the relatively recent return of some 6 million refugees and displaced people, who increased the demand for goods and services. The implementation of special programs (demobilization, elections, demining, repatriation and emergency activities in support of resettlement) demanded a substantial financial effort, both on the part of donors and the GRM. The external financing requirements for these activities in 1994 amounted to $184 million. Internal financing amounted to 9 percent of current revenues. The restrictive fiscal policy implemented since 1987 remained in place in 1994, despite the rapid growth in requirements. The priority given to investment is reflected in the increase of 54 percent of total public investment in 1994. Notwithstanding these increases, the available resources are grossly inadequate to meet the needs identified in the post-war period. In this context, the co-financing of essential public services by the private sector must be encouraged (even if such a policy only brings results in the medium-term as incomes increase). NGO's will also have an important role to play in those services that the state cannot provide.

The GRM consolidated the PRN and PTIP in 1994 into a single program and amount allocated to each of the following objectives determined according to their relative priorities:

- Resettlement of the population, including roads and bridges, rural water supply, primary education and primary health care in rural areas (PRN);
- Construction of infrastructure which will improve the efficiency of private investment (reducing the currently high capital/output ratio). At the current moment, this can best be achieved through the rehabilitation of primary roads (PTIP);
- Health services in urban areas, including general and central hospitals (PTIP);
- Secondary and university education (PTIP); and
- Strengthening the civil service at the national, provincial and district levels (PTIP).

In the investment program prepared by the GRM, the share of total public investment allocated to actions in support of resettlement (the PRN) will increase from 10.5 percent in 1993 to 29 percent in 1994 and 31 percent in 1995. Any shortfall in foreign financing for investment projects is supposed to be accompanied by a pari passu reduction in the budget deficit before grants. In addition, domestic resources saved by any postponement in the implementation of projects are supposed to be used to increase repayments to the banking system by the GRM (see the Money and Banking Section).

Table . Distribution of Public Investment by Objective (Million U.S. Dollars)

	1994			1995			Structure (%)	
Objective	Internal	External	Total	Internal	External	Total	1994	1995
Resettlement (PRN)	26.6	92.1	118.7	31.9	99.8	131.7	28.6	30.8
Health & Social Action	2.5	7.4	10.0	1.2	6.5	7.8	2.4	1.8
Education	10.0	25.2	35.2	11.6	34.6	46.2	8.5	10.8
Rural Water Supply	2.0	7.1	9.2	3.2	10.8	14.0	2.2	3.3
Rural Roads & Bridges	12.1	52.3	64.4	15.8	47.8	63.6	15.5	14.9
Support to the Family Sector (PTIP)	5.2	33.1	38.3	6.9	32.4	39.3	9.2	9.2
Infrastructure Development (PTIP)	24.0	131.2	155.2	25.9	137.8	163.7	37.4	38.3
Health (other than that related to resettlement) (PTIP)	5.2	18.3	23.5	4.6	17.9	22.5	5.7	5.3
Education (other than that related to resettlement) (PTIP)	2.7	8.2	10.8	2.8	8.2	10.9	2.6	2.6
Public Sector Capacity Building	19.6	48.9	58.5	17.0	42.2	59.2	16.5	13.9
Total Programmed Investment	83.3	331.8	415.0	89.1	338.3	427.3	100.0	100.0

4. Sectoral Distribution of Investment

a. Agriculture

The GRM's medium-term strategy in the agricultural sector is to attain a level of food production which guarantees sustainable food security (which in order to achieve sustainable economic growth also requires that the rural economy continues its transition from a subsistence to a market-based economy). In the immediate future, the principal mechanism for achieving these objectives will be through an increase in the cultivated area using traditional extensive cultivation practices and through the timely provision of inputs to the family sector.

The livestock herd was decimated by the war, drought and disease. Rehabilitation of this herd is essential for the future stability of traditional agricultural systems in southern Mozambique where cattle constitute a reserve of value for many smallholders. Resources programmed under the PRN account for only 7 percent of total programmed investment in the agricultural sector for the period 1993-1995. There are two major areas of concentration: 1) rural extension (48 percent of programmed PRN investment), including rehabilitation of housing for extension workers, small-scale projects for granaries and processing industries (this also includes seed multiplication projects where they have been proposed by extension agents) ; and 2) livestock (29 percent), including the rehabilitation and construction of 383 dipping tanks and 34 projects for animal breeding, traction and small ruminant development.

Expansion of commercial networks in rural areas is a prerequisite for the recovery of agricultural production by providing smallholders with a market for agricultural surpluses and a source of incentive goods and agricultural inputs. The total cost of rehabilitating the commercial network destroyed and damaged by the war (3,699 shops) is estimated at $50 million.

Access to rural areas is fundamental to the process of resettlement and a prerequisite to the restoration of rural production and trade. The rehabilitation of roads and bridges has been given priority in the PRN, accounting for over 50 percent of programmed investment. Projects in the PRN program are primarily secondary and tertiary roads (with some repairs to urban roads in provincial capitals). The PRN complements activities financed under the PTIP which is essentially geared towards primary roads. The programmed investment meets virtually all of the requirements identified by provincial governments for 1994 and 1995 but coverage drops to about two-thirds in 1996.

The GRM intends to expand the territorial and demographic coverage of rural water services from the current level of 18 percent of the rural population to 30 percent in 1996, reaching up to 50 percent by the year 2000. The water supply sector will absorb 9 percent of the total public sector investment program in 1994 with most of the remainder financed under the PTIP. All the requirements identified by the provincial governments under the PRN have been satisfied with the available resources for 1994 and 1995. The PRN foresees the rehabilitation of 665 wells, 200 boreholes and 166 small water supply systems as well as the construction of 2,075 wells and 771 boreholes nationwide.

b. Health

The network of health facilities was devastated by the war. One in three health posts and one in five health centers were destroyed or became non-operational. As a result of the massive destruction of health infrastructure in the rural areas (over 1000 units), the density of the health network deteriorated from 9,730 persons per health facility in 1985 to 12,900 in 1992. Because of the demographic changes expected in the post-war period, the pressures on the health care system will be enormous. The GRM intends to restore an effective network of primary health care facilities in rural areas, gradually transforming health posts into min-health centers. Targets set by the Ministry of Health aim at a network of 211 health centers, 745 mini-centers and 450 health posts by the year 2000. Resources programmed under the PRN are largely directed towards the rehabilitation of the primary health network: 248 health posts and 34 health centers are programmed for rehabilitation compared to construction of 190 health posts and 4 centers. Achievement of this program would result in a reduction in the current population per primary health care facility ratio to 13,500 in 1996 (equivalent to the 1980 level). More than 25 percent of the 6,000 rural water pumps and 50 percent of small systems are not operational. Water service coverage in the rural areas is estimated at 29 percent, including small systems. The PRN accounts for about half of the programmed investments. Available resources cover 83 percent of the requirements identified by the provincial authorities for 1994 but less than 30 percent of requirements for 1996 and subsequent years.

c. Education

By 1992, 47 percent of the 5,743 first level primary schools and 13 percent of the 199 second level primary schools (excluding the capital city of Maputo) had been destroyed or were closed down, affecting approximately 1.2 million students. As a result, only about 50 percent of the school age population have access to primary education. At the same time, the quality of primary education in urban areas is very poor with overcrowded classrooms, low teacher training and a shortage of basic training materials. The main long-term objective of the education sector is to provide universal primary education. The short to medium-term priority is to improve the quality of education, to increase the rate of enrollment at the primary level and to increase output at the secondary and tertiary levels. The attainment of these goals will require the rehabilitation of the primary education network through reconstruction and building of new schools. Another key objective is to secure the transition from one level to another. The improvement of quality will be achieved through training and retraining of teachers, a review of the curriculum and the supply of basic teaching materials. The GRM's policy is to expand coverage and the efficiency of the educational system with priority given to basic education. Targets set within the Jomtien Declaration call for an increase in the gross enrollment rate in first level primary schools from the current level of 59.7 percent to 86 percent by the year 2000. The PRN accounts for one-fifth of public sector investment in the education sector for 1994 and 1995. These funds are primarily directed towards the rehabilitation (1,114 schools) and construction (709 schools) of first level primary school facilities. With an investment of this order, the primary school enrolment rate is expected to increase to 73 percent. Programmed resources only meet half of the requirements identified by provincial governments for the period 1994-1996.

d. Local Governments

Rehabilitation of local government offices, residences and the acquisition of major equipment is a major preoccupation of provincial governments. Working conditions at the district level are appalling. Of the country's 128 districts, 47 have no suitable office space, 50 have no residences for the administrator, 30 have no vehicles and 50 have no means of telecommunications. Conditions are still worse at the administrative post level where the vast majority lack offices, vehicles and radios. Resources for capacity building in local government are virtually all channelled through the PTIP. The national programs are primarily concerned with the reform of local government and training, not with improved working conditions. The vast majority (95 percent) of the requirements identified in the provincial programs remain unsatisfied.

Money and Banking

I. Structure of the Financial Sector

Mozambique has a rudimentary financial system. The system is comprised of: 1) Banco de Mocambique (BM), the central bank; 2) two state-owned banks - Banco Comercial de Mocambique (BCM), which was part of BM until 1992, and Banco Popular de Desenvolvimento (BPD); 3) three privately-owned commercial banks - Banco Standard Totta de Mocambique (BSTM), Banco de Fomento e Exterior (BFE), and Banco Portugues do Atlantico (BPA); 4) an insurance sector dominated by the state-owned insurance company - Empresa Mocambicana de Seguros (EMOSE) but also includes (since 1992) two privately-owned insurance companies (IMPA and IGI); and 5) the Sociedade de Investimentos e Estudos Financeiros (SOCIEF), an institution owned by the GRM and state banks which was established to provide secondary market support for the development of money and capital market instruments. Standard Bank of South Africa opened a representative office in Maputo in December 1993. Equator Bank established an office in Maputo in 1994 after having an off-shore presence for a number of years. A new joint venture bank, Banco Internacional de Mocambique (BIM), was recently formed in February 1995 between EMOSE, the Community Development Fund and the Portuguese Commercial Bank of Portugal. BIM will be capitalized with MT 28 billion. Unlike other recent new entrants, BIM will establish a subsidiary (as opposed to a branch) of a foreign banking institution. It will also, unlike other recent entrants, establish itself outside of Maputo in the commercial center of Beira. With the approval of new leasing legislation in October 1994, a new joint venture company, EDESA, will be able to establish a leasing market in Mozambique (the International Finance Corporation is also interested in establishing a leasing operation). EDESA could play an important role in mobilizing term deposits and providing longer-term leasing contracts for the development of the economy.

A. Pre-Independence

The general banking law in Mozambique was largely based on colonial Portuguese law from the early 1960's. Before independence, nine banks operated in Mozambique with the Banco Nacional Ultramarino (BNU) operating as the issuing bank for the Portuguese government in Mozambique (as it did in other former Portuguese colonies), thereby operating as the central bank. All of the other banks were Portuguese with the exception of Banco Standard Totta de Mocambique (BSTM), which was partly owned by Standard Chartered Bank of the United Kingdom. Banco Commercial de Angola originated from Barclays Bank but was fully Portuguese-owned by the time of independence. At independence, there were purported problems of solvency with some of the banks and all nine institutions were subsequently restructured.

B. Post-Independence

After independence, the Bank of Mozambique was formed in 1975 from the BNU in conjunction with three other banks and operated as the central bank. The Bank of Mozambique became the largest financial institution operating in Mozambique with more than 95 percent of total financial sector assets. It also acted as the issuing bank, state bank, foreign trade bank, and, until recently, the main commercial bank. It also had, until recently, monopoly control over foreign exchange transactions. BM became a typical mono-bank in a centrally-planned economy, ostensibly performing both central banking and commercial banking functions but in reality acting as the accounting arm of the Ministry of Finance.

The Banco Popular de Desenvolvimento was created in 1977 (from the consolidation of the Instituto de Credito de Mocambique and the Montepio de Mocambique) to form a development banking institution, although it concentrated on short-term agricultural finance. Two other banks (Banco Pinto e Sotto Mayor and Banco de Fomento de Mocambique - the latter being the only development bank prior to independence) ceased operations completely in 1977. All but one of the private banks were nationalized in 1978 and merged into state-owned banks. The only financial institution not restructured or nationalized, BSTM (with Standard Chartered and Banco Totta e Acores holding the main shares), operated as the only private sector financial institution in the country. However, BSTM drastically reduced its branch network after independence due to lack of business and began to concentrate on lending for short-term purposes only.

Post-independence rationalization of the insurance sector led to the formation of the country's only insurance company, the Empresa Mocambicana de Seguros (EMOSE) in 1977. EMOSE was formed from the four Portuguese insurance companies and the 28 agents that were based in Mozambique prior to independence. The company provided short-term and life insurance and pension services. Legislation was passed in 1992 permitting competition in the insurance business and a number of South African and Portuguese institutions showed immediate interest in establishing offices in Maputo. A new insurance company was set up in 1993 with capital from Portugal and other Portuguese-speaking countries. The GRM set up a subsidized and longer-term agricultural credit fund, the Caixa de Credito Agrario de Desenvolvimento Rural (CCADR), in 1988 but after a poor record new lending stopped in 1990 as its resources had been exhausted. CCADR was primarily targeted at the resettlement of veterans into agriculture-related activities. CCADR was operated by BPD on behalf of the GRM but did not cover the costs of operating the fund. The other main financial institution is the Sociedade de Investimentos e Estudos Financeiros (SOCIEF), established in 1988 to handle government bond issues and to develop trading of stocks and shares. SOCIEF is owned by BPD, EMOSE, BSTM and other public and private enterprises. SOCIEF's performance has not been very successful to date and the volume of trade has been negligible.

1. Financial Sector Reform 1987-1994

Mozambique's financial sector was dominated by BM which operated as the central bank and the largest commercial bank until 1992. After independence, in part reflecting the ad hoc evolution of its functions, the BM experienced long delays in the preparation of the definitive monetary accounts, with adverse effects on monetary policy. Accordingly, priority in reforming the banking system was given to redesigning the basic accounting system in order to provide definitive analytical monetary accounts on a timely basis. In 1990, the GRM began separating the commercial banking functions of BM and streamlining its accounts as an initial step in setting up a modern banking system. Accounts of the commercial and central bank functions of BM were separated in mid-1991. Separate legislation was developed with a new Central Bank Act in 1991 and a Banking Act in 1992 which established the legal and institutional framework for prudential regulation and supervision of the banking system. The separation of the central banking functions and the commercial banking functions of BM was achieved in 1992 (as opposed to the 1990 target date). A separate commercial bank, Banco Comercial de Mocambique (BCM), was established and the staff from BM were divided between the two institutions. Regulations and procedures were issued for licensing of new banks and two private banks, BFE and BPA, were licensed and began operations.

Implementation of financial sector reform in the first few years of adjustment moved slower than expected. Progress towards enhancing transparency of the financial system revealed that severe distortions existed and there were greater imbalances in the financial and enterprise sectors than had been initially realized. Explicit budgetary subsidies to state enterprises were reduced from 8.5 percent of GDP in 1986 to less than 1 percent of GDP by 1992. However, implicit subsidies proved more difficult to eliminate. Stricter explicit credit rules were imposed and the GRM adopted the principle that bank loans would not be granted to cover operating losses of public enterprises (following its assumption in 1987 of financial responsibility of bad loans of public enterprises - which amounted to 14 percent of GDP). Nevertheless, the publications of BM and BCM's accounts in 1993 revealed that substantial additional credit to public enterprises had in fact been provided from 1987-1992, with the accumulation of non-performing loans assigned to BCM (roughly 7 percent of GDP).

In addition, control of monetary expansion proved difficult. Part of this was related to the separation of BM and BCM, including the final assignment of certain foreign exchange assets and liabilities and the fact that BCM could not comply with the requirements of the adopted banking regulations. Other issues include the increase in interbranch assets liabilities of the two state banks and an expansion in inter-enterprise liabilities. This occurred as tighter lending criteria were adopted in 1993 and explicit credit to public enterprises was effectively stopped. Imbalances in the financial sector reflect underlying problems in the enterprise sector, where large information gaps still exist on critical variables of enterprise behavior and efficiency. In response to this, the World Bank implemented the Second Economic Recovery Credit (SERC) in 1994 to address what had become a very thorny problem of inter-related macroeconomic distortions between financial and enterprise sector reform.

Mozambique's financial and banking sector has not been able to fulfill the key economic development role of mobilizing savings and making resources available for investment as is amply illustrated below. Until recently, many banking activities were only provided by BCM and customer were permitted to have a banking relationship with only one bank. The institutional framework for mobilization of savings is extremely weak. There are few banking and financial entities and concentration of total financial resources is highly concentrated in state institutions. Commercial banking is dominated by the two state-owned banks. Between the two of them, they control 89 percent of all commercial banking assets, 89 percent of all loans, and 86 percent of all deposits. BCM alone controls 70 percent of all commercial banking assets. Given access to central bank overdraft facilities, neither bank has an incentive to attract and mobilize domestic savings. Banking activity has been segmented and uncompetitive. BPD has mainly lent to agriculture, although it has increasingly diversified its lending portfolio, particularly into commerce and trade-related activities. BPD also took over the savings collection functions of the old postal savings system which provides a nationwide deposit taking network, although limited at present. BCM, on the other hand, has historically been associated with the state enterprise sector. Until recently, it was the only bank engaged in foreign exchange dealings, which gave it a monopoly on trade financing. As a result of the reform process, BCM now competes with BPD and the other commercial banks for foreign exchange business (however, BCM continues to dominate the foreign exchange business). While inefficient by any modern standards, the two state banks together provide a comprehensive nationwide service through their 200 branches, agencies and collection posts.

In the past, the state banks have had no pressing need to mobilize domestic sources of funding as the central bank has provided a cost free source of funds on overdraft and many of the banks have been highly liquid as a consequence of lax GRM fiscal policy. Credit allocation was dictated by the national plan and there was no requirement for banks to assess and price lending risks. Some progress has been made with respect to the allocation function of the banks. BCM and especially BPD have been increasingly moving away from servicing the state enterprise sector and private sector activities now account for at least half of their business. With savings mobilization, however, BCM has made less progress as it continues to rely on the central bank as a source of liquidity.

There have been two sources of leakage from the state banks, particularly from BCM. One has been a continuation of lending to non-performing state-owned enterprises (credit), representing most of the stock losses in BCM. The second source of leakage has been other items net (OIN) which are unidentified assets and liabilities, mainly representing a growing volume of transitory (inter-bank and inter-branch) items. This represents a serious flow problem in the banks.

The thirty largest borrowers in the banking system, representing 50 percent of all commercial bank lending, indicates a very clear relationship between ownership and loan performance. All enterprises with performing loans are private companies. On the other hand, the subset of enterprises with non-performing loans are mostly state-owned enterprises. The GRM directly and through its majority-owned entities (i.e., the state-owned banks, BCM and BPD) has controlling equity interests in many enterprises. BCM, as of 1993, held the following equity positions in major companies in Mozambique: Mabor Tire (71 percent); Safrique (86 percent); Socimo (33 percent); Acucareira de Mocambique (30 percent); Companhia do Buzi (31 percent); Maragra (25 percent); Texmoque (10 percent); and Sociedade Noticias (55 percent). This equity interest in some cases translates into oversight of the management (e.g., the president of the board of Mabor Tire, a JVC, is also the president of BPD). Almost all of these equity positions are in fact bad debts that have been turned into equity. In addition, there is not a clear distinction between the public and private sectors. A JVC is considered private even if the majority of shares or ownership is controlled by the state.

While direct budgetary subsidies to state enterprises decreased to about one percent of GDP by 1993 and 0.4 percent in 1994, implicit subsidies through other means (through the state-owned banking system and/or exemptions and non-payment of duties and taxes) remained significant. A high percentage of non-performing loans to the banking system is accounted for by large industrial state firms. For example Caju de Mocambique, Emocha, Cimentos de Mocambique (which was recently privatized) and Vidreira are some of the largest bad debtors to BCM and are examples of this problem. This transfer of scarce resources to loss-making state companies has crowded out access to credit by the private sector, further constraining output recovery. Rather than being able to contribute towards growth, many enterprises still are a drain on state resources. The financial condition of banks in Mozambique will remain weak as long as their major client base is comprised of poorly performing, state-owned enterprises.

Another constraint is the lack of capacity. Education levels of staff in the banking system in Mozambique are extremely low (a heritage of low levels of education during the pre-independence period). The majority of staff in the banking system in Mozambique have only a primary education (38 percent) or a small amount of secondary education (37 percent). Only 3.6 percent of staff have any form of tertiary education. Within the commercial banking system (excluding BM), this proportion drops to less than 3 percent. The above numbers exclude staff involved in security, cleaning, gardening and chauffeuring duties so the staff numbers reflect the actual totals of staff involved in the day to day banking work of the institutions in which they are employed. Under the SERC a companion Financial Sector Capacity Building Project was undertaken in 1994 to provide training and upgrade skills to the staffs of financial institutions. A Banker's Training Institute of Mozambique was inaugurated in October 1994 to provide training for banking staff in all eleven provincial centers. The first banking training course is scheduled to begin in early 1995.

Modern monetary management will not be possible without better data capabilities within BM. Under the SERC, BM is producing a central bank quarterly economic bulletin, which will gradually involve economic analysis. In 1992 a banking supervision department was created in BM. Unfortunately, staffing of this department did not take place until 1994. Regulations on provisioning against bad and doubtful debts, capital adequacy, and loan limits/exposures, based upon internationally accepted practice, are being put into place under the SERC. Over time, the banking supervision department will develop a system of off-site reporting for the commercial banks so that their performance can be continually monitored for potential problems. BM has centralized the system of foreign exchange management (away from various government departments and agencies) in order to provide central accountability to the donor community which provides most of the country's foreign exchange resources. As the system improves further, BM will eventually delegate foreign exchange allocation to the commercial banks, thereby greatly streamlining allocative mechanisms.

Mozambique does not have a strong tradition of accounting and auditing. Only BSTM had produced audited accounts by mid-1994. The production of BM accounts was complicated by its amalgamation with BCM, prior to 1992. During the fourth quarter of 1994, BM and the two state-owned banks had their accounts audited for the very first time. This was an important step but the auditors identified numerous problems remaining in the accounts of these three institutions. Absence of timely, audited central bank accounts has impaired the capacity of the monetary authorities to undertake proper policy initiatives. A major accounting problem has been caused by the inability of the banks to clear inter-bank and inter-branch accounts. This led to a buildup of unreconciled transitory accounts which has created a serious macroeconomic problem. A 1993 IMF mission reviewed the payments system and clearing mechanisms and recommended the utilization of external assistance in the central bank to help address this problem. Under the SERC, the GRM plans to reduce the level of transitory accounts in the banking system and streamline the overall payments system.

The menu of financial assets is very limited, primarily consisting of cash and deposits. Other assets are not available or are issued only on an irregular basis, e.g., government securities and dollar-denominated bonds. Government securities, which paid interest partly in U.S. dollars, were issued in early 1988 as part of a railroad debt restructuring operation. SOCIEF issued around MT 10 billion in cash bonds in late 1989, which served as both a medium-term investment vehicle and a short-term means of exchanging dollars and local currency at rates between those in the official and parallel markets. Such operations, however, were overtaken by the introduction of the secondary foreign exchange market. Credit operations are limited to simple commercial and investment loans and mortgages. During the 1980's and early 1990's instruments of monetary control were very limited, either because they were rigid (as in the case of interest rates, see below) or were not effective. Reserve requirements on bank deposits were only recently introduced. The discount window at BM was rarely used because of excess liquidity in the system. The bank-by-bank credit ceilings have not been binding because they do not carry sanctions in the case of noncompliance.

The banking system in Mozambique offers only a limited range of deposit facilities. Demand (current) accounts total almost 90 percent of the deposit base of the banking system. This heavy preponderance of demand deposits is a consequence of two factors. First, is the fact that a historical bias developed for demand deposits because BNU never offered alternative deposit facilities. BM followed this tradition after independence and only began to accept time deposits on a limited basis in 1987. Second, economic considerations have weighed heavily against mobilizing longer-term, higher-interest bearing time deposits since 1987. In an environment of high excess liquidity and credit ceilings (imposed since 1987), banks have had little incentive to pay higher rates of return on funds they do not need. BM has even refused to accept time deposits for some very large depositors, such as EMOSE, which obliged these companies to hold their funds in low-interest bearing demand deposits.

As the vast majority of deposits are held as demand deposits, the GRM instituted interest payments on these accounts (up to 2 percent from 1981-1986 and 3 percent thereafter). Consequently, banks pay a nominal 3 percent (most in reality pay zero interest) interest rate on demand deposits. A major consequence of having so small a share of total deposits in interest-bearing time deposits is that interest rate policy is largely irrelevant for mobilizing savings. From 1980-1989, the total deposit base of the banks increased slightly less than 30 percent per year, representing a real decline in deposit levels (the CPI averaged more than 40 percent during this time period). The deposit base is geographically concentrated with 60 percent of the deposit base originating in Maputo, reflecting the low level or non-existence of financial intermediation in rural areas.

Channelling foreign savings through the banks has also decreased the incentives for domestic deposit mobilization. Foreign sources of relatively cheap funds crowded out domestic deposit mobilization within the set credit ceilings. The willingness of enterprises and households to hold bank deposits has been discouraged, in addition to the highly negative real interest rates on current accounts, by the paucity of deposit facilities and instruments, high transaction costs and poor service offered by banks. The combination of distortions and lack of confidence means that a significant part of the deposit base is concentrated in a few large accounts, e.g., EMOSE holds large deposits and large domestic traders are the largest private depositors with 30-40 percent of deposits.

The demand side of the financial market is weak. Few private Mozambican businesses are creditworthy. Almost all state enterprises are debt-ridden and have little short or long-term promise to move to positive bottom lines. Overall, Mozambique's current banking system is not competitive and provides limited banking support to the economy. The allocation of a large proportion of total financial resources has been governed by priorities of the state, not by the financial integrity of the borrowers. Largely, in response to this, the World Bank developed and implemented its SERC in 1994 which addresses the difficult and related linkages between financial sector and enterprise reform.

Inefficiency in the banking system is causing major problems for those businesses that are solvent or have the potential to be so. The poor performance primarily results from the lack of competition and relative predominance of state-owned banks who suffer from management and capacity weaknesses. Common problems include long delays in undertaking any standard bank transaction, e.g., opening import letters of credit takes an average of four weeks at BCM, partly because it is very slow in communicating with correspondent banks. Confirming import letters of credit regularly takes several months (by which time the original terms will often have expired and need to be renegotiated, adding further to the delays and administrative hassles for the concerned firms). In addition, access to credit to the private sector has been restricted as most credit is absorbed by loss-making state-owned enterprises.

In view of the underdeveloped banking system and uncertainty associated with foreign exchange availability and exchange rates, many exporters experience difficulties in accessing trade finance for export production and sales. The existence of bank credit ceilings to control inflation has contributed to restrict overall credit expansion, including trade finance for exports. Commercial banks are not willing to assume the risk of exporters' non-performance, even if exporters have confirmed export letters of credit from countries with low political risk. Imperfect information and resulting risk perceived by banks is especially high in the current stage of export development in Mozambique, which is characterized by small, irregular or new exporters with no track record and collateral. Therefore, short-term lending for exporters is credit-line based rather than export letter of credit-based. The lack of working capital to finance inputs has forced many manufacturers to rely on subcontracting arrangements while others are financed through their parent companies.

Given the acute cash flow and working capital shortages faced by many manufacturing firms, the short-term cost of borrowing in local currency at an interest rate of 46 percent is perceived as too expensive. Consequently, access to foreign currency-denominated short-term loans to finance imported inputs seems an attractive alternative, especially to those less sensitive to exchange rate fluctuations. Some commercial banks have started to extend foreign currency denominated loans but it is unclear whether these loans would be included in the credit ceilings established by BM.

Banking institutions are present mainly in provincial capitals. Large traders as well as informal traders indicate that scarcity of capital and the high cost of capital limit their actions in marketing. Short-term interest rates of 46 percent per annum necessitate fairly high turnover rates of stocks. Traders do not realize profits in using capital to purchase commodities retained in stocks. Instead, traders seek to buy and sell rapidly, with a minimum of lag time. Small-scale traders lack the collateral necessary to obtain bank funding. No credit lines specifically for agricultural marketing were available during the 1993/1994 marketing year, although during the 1992/1993 marketing year there was a small Fundo de Comercializacao available for traders. However, it was discontinued due to lack of repayment. The short terms and high interest rates of commercial bank loans, when available, limit the usefulness of such credit in commodity storage and marketing.

Savings mobilization was and is poor. Domestic dissaving is extreme and most of it is from the private rather than the public sector, largely as a result of severe financial repression in addition to disruptions to agricultural activity because of the war and the resulting impoverishment of the rural population. Financial repression has forced a lot of financial activity into the informal sector which will not return until banking system reforms are implemented, banking services improve and returns on financial savings improve.

Little financial intermediation takes place in rural areas, largely as a result of the war and inappropriate policies. What activity that does take place is usually through informal associations (called Xitiks) or through trader credit, although the number of small savings and loan associations is gradually increasing.

The non-performing loans at BCM were identified in 1993 and loan loss provisions established.

However, accounting lags still amounted to two or three months. In order to control OIN, the monetary authorities (BM) adopted the following new policies in 1994. First, the internal procedures of BM regarding letters of credit were modified to avoid foreign exchange losses and hidden subsidies to importers. Second, a new methodology to calculate bank-by-bank ceilings was adopted to force banks to be mindful of the expansion in OIN. The ceilings are now set in terms of net domestic assets which includes OIN. This action causes banks to focus on both of the major elements of monetary expansion in the economy - credit and transitory accounts. The new system of allocating credit ceilings is also based, inter alia, on mobilization of deposits and overdraft position with the central bank. Third, BM contacted key correspondent banks and international institutions to reduce reporting delays and took steps to reduce the reporting lags that had given rise to unplanned credit expansion to importers. The payments system and accounting practices in the financial sector are being improved as recommended by a July 1993 IMF mission. BM instructed commercial banks to expedite the closure of their accounts to allow BM to monitor monetary and credit developments in a timely manner. BM is now using base money and exchange rates as early warning policy indicators. The authorities attempted to maintain their policy to keep interest rates positive in real terms during 1994, raising the rediscount rate to 69.7 percent in late November in order that proper signals would be given to the private sector for the allocation of resources. The Treasury, in cooperation with BM, is making preparations for the auctioning of government securities, which will play an increasing role in liquidity management.

The monetary authorities are relying on a bank-by-bank credit allocation system in order to ensure adherence to their macroeconomic targets. Each commercial bank receives a quarterly ceiling up to which it can extend credit with domestic resources. Credit financed through import support funds is excluded from the ceiling. Banks exceeding their allocation, in principle, suffer a reduction in their next quarterly ceiling. Aside from credit ceilings the monetary authorities rely on reserve requirements to control the banks' liquidity. Since 1992, banks must leave 25 percent of their deposit base with BM, on which they receive no interest payments. To provide incentives for lending to productive activities, the authorities pooled a portion of the bank-by-bank credit allocation, which was made available only for medium and long-term credits. It was additional to each bank's credit ceiling but formed part of BM's overall credit target. Given their relatively high levels of liquidity (excluding BCM) in the face of credit constraints, commercial banks had little incentive for accepting time deposits, which had to be remunerated at relatively high rates. Therefore, banks have a strong preference to accept only demand deposits, which are remunerated at only a token rate (about 3 percent but in most cases are zero). The structure of lending rates also encouraged short-term operations. At the end of 1991, 65 percent of the stock of credit had a maturity of less than one year. This included many non-performing loans of state enterprises.

No simple linear sequencing of reform is possible because so many essential elements are interconnected. In particular, budgetary and monetary control, financial sector reform, and enterprise reform are inseparable as loss-making enterprises put pressure on the budget or undermine the viability of commercial banks through non-repayment of loans. Government efforts to impose a hard budget constraint on state enterprises have been partially successful, but have to some extent also resulted in shifting enterprise losses from the budget to the banking system and to inter-enterprise debt, undermining attempts to create a truly commercial banking system and, in turn, making fiscal and monetary control difficult. It is also difficult to impose hard budget constraints on state enterprises operating in so-called strategic sectors, as there are many subtle ways of extending or tolerating indirect fiscal transfers, giving rise to soft budget constraints (negotiable subsidies or taxes, non-payment of dividends or counterpart funds, delinquency on debt service, credit reschedulings, enforceability of suppliers contracts, and the fungibility between investment and current expenditures). Rapid privatization or closure of many state enterprises becomes complicated because many potentially viable firms are financially distressed due to debts owed by other non-viable enterprises and price distortions. In addition, there are relatively few domestic entrepreneurs and domestic savings are negative so privatization will have to take place with foreign investment. The process of reform in Mozambique is not unlike one of opening up a series of black boxes with respect to information flows, and progressively turning off taps with respect to bringing monetary, fiscal and enterprise accounts under control. Mozambique's financial sector was largely destroyed by almost fifteen years of socialism. In a sense, the task ahead represents forming, rather than reforming the financial sector. The SERC was specifically designed and implemented to address this formidable task.

B. Interest Rates

The following tables illustrate the history of interest rates in Mozambique. Interest rates were kept at a low level by the Ministry of Finance and BM from 1981-1986 with a complex structure not only varying by maturity but also designed to favor certain activities and institutional types of borrowers or depositors. Before 1987, the maximum nominal lending rate for parastatals was 7 percent and there was a strong demand for these essentially free funds from the banks.

One of the main planks of financial reform under the ERP has been the attempt to move toward positive real interest rates, both to mobilize savings and to regulate credit provision. Interest rates were approximately tripled at the beginning of 1987, to a range of 14-28 percent on loans and 12-20 percent on time deposits. In the context of the shift to commercial standards, emphasis was placed on payment when due. The structure was considerably simplified two years later with the number of specified lending rates reduced from 30 to 16. Several categories of activities were combined and the institutional preferences eliminated. This simplification was accompanied by a second increase in levels, which was fairly small for agriculture and industry (0-4 percentage points) but larger for less favored activities such as commerce (6-10 percentage points). Two more fairly small general increases followed in 1989 and 1990. Virtually all interest rates at that time remained negative in real terms. Real interest rates on loans became positive for the first time in late 1991. The Mozambican authorities reduced the BM discount rate by 2 points to 43 percent in October 1993 in response to an apparent decline in inflation. Although the 180 day time deposit rate was briefly negative in real terms in late 1993, it returned to positive levels in

1994.

Under the ERP, interest rates have been progressively deregulated. Although progress has been made on achieving positive real lending rates, it has been achieved with very high nominal interest rates. BM currently only has a discount rate to provide very short-term liquidity to the banking system. Although not an issue for most banks, which are currently highly liquid, it is pertinent for BCM which is highly illiquid. BCM borrows on overdraft from the central bank at no cost, putting it at an advantageous position compared to other banks. Under the SERC, the central bank will introduce a more comprehensive discount policy, applicable to all banks on the same basis, which will provide normal short-term liquidity (up to 180 days). Banks will no longer have access to overdraft financing from BM and will pay a rate of interest for emergency liquidity support that would encourage primary recourse to deposit mobilization.

As for demand deposits, which constitute over 90 percent of deposits held by the public and hence the bulk of financial assets, the interest rate paid has remained no higher than 3 percent. In practice, no interest is reportedly paid on some of these, and in view of their liquidity banks are reluctant to seek new deposits, especially high cost time deposits. At the same time, the commercial incentive for banks in lending operations continues to run counter to the official aim of favoring certain activities by charging lower rates for them and there is still little flexibility in the structure for banks to account for risk.

Lending and time deposit rates were adjusted quarterly to keep them positive in real terms and the sectoral discrimination in lending rates was eliminated. The monetary authorities began using the BM's rediscount rate as the anchor in May 1993 which triggered changes in the maximum lending rate and key deposit rates. Until recently, the maximum loan rate has been the discount rate plus 3 percent. The discount rate was meant to be changed on a quarterly basis to maintain a positive real interest rate but in fact loan rates vary and some are offered at a technically negative rate, partly because of intense competition among the commercial banks and partly because banks are forced to offer low rates to keep the business of enterprises that otherwise can get cheap credit from donors. In June 1994 interest rates were fully deregulated and their determination left to the commercial banks. With all interest rates liberalized, the only GRM determined rate in the system is the rediscount rate. Under IMF agreements, this rate is adjusted periodically to keep it positive in real terms (with some lag). High rates of inflation pushed the nominal rediscount rate up to 69.7 percent in November 1994 (which had obvious negative implications for anything but the practice of continuing short-term lending activities). Nonetheless, the commercial banks offer significantly lower rates than this to their prime borrowers, with rates in the 30's not uncommon. At such rates, the cost of finance is sharply negative in real terms for a borrower. However, given that most deposits attract no interest in Mozambique, the interest rate spread is particularly attractive for a financial institution.

Structure of Interest Rates: Deposits

Period	Designation	Demand Deposits	Time Deposits				
			90 Days	91-180 Days	180-365 Days	1-2 Years	More than 2 Years
1/1/81-12/31/86	Population & Cooperatives	2.0%			3.0%	4.0%	6.0%
	Private Business	-			2.0%	3.0%	4.0%
	Other Entities	3.0%					
1/1/87-21/31/88		3.0%	12.0%	13.0%	16.0%	18.0%	20.0%
1/1/89-2/28/90		3.0%	14.0%	15.0%	18.0%	20.0%	22.0%
3/1/90-10/31/90		3.0%	18.0%	19.0%	20.0%	22.0%	24.0%
11/1/90-6/30/91		3.0%	29.0%	30.0%	31.0%	32.0%	34.0%
7/1/91-9/22/91		3.0%	29.0%	30.0%	32.0%	33.0%	35.0%
9/23/91-3/31/92		3.0%	32.0%	33.0%	34.0%	35.0%	36.0%
4/1/92-11/9/92		3.0% Max.	38.0%	39.0%	40.0%	41.0%	42.0%
11/10/92		3.0% Max.	38.0%	39.0%	43.0%	44.0%	45.0%
5/4/93		3.0% Max.	38.0%	22.5% Min.	43.0%	44.0%	45.0%
10/12/93		3.0% Max.	38.0%	21.0% Min.	Negotiated	Negotiated	Negotiated

6/1/94	Free (0%)	Free	Free	Free	Free	Free

Structure of Interest Rates: Lending
January 1, 1981 - December 31, 1986

Designation		Sectors				
		State	Cooperative	Famil y	Others	Population
Agriculture	Long-term	4.0%	3.0%	4.0%	5.0%	0.0%
	Short-term	5.0%	3.0%	4.0%	6.0%	0.0%
Fishing	Long-term	5.0%	3.0%	4.0%	6.0%	0.0%
	Short-term	6.0%	3.0%	4.0%	7.0%	0.0%
Industry & Tourism	Long-term	5.0%	4.0%	0.0%	6.0%	0.0%
	Short-term	6.0%	4.0%	0.0%	7.0%	0.0%
Transport	Long-term	5.0%	0.0%	0.0%	6.0%	0.0%
	Short-term	6.0%	0.0%	0.0%	7.0%	0.0%
Commerce & Hotels	Long-term	5.0%	4.0%	0.0%	6.0%	0.0%
	Short-term	7.0%	4.0%	0.0%	8.5%	0.0%
Other Activities	Long-term	5.0%	0.0%	0.0%	6.0%	0.0%
	Short-term	7.0%	0.0%	0.0%	8.5%	0.0%

Housing		5.0%	4.0%	0.0%	6.0%	6-10%
Construction		0.0%	0.0%	0.0%	0.0%	8-10%

Structure of Interest Rates: Lending
January 1, 1987 - December 31, 1988

Activities	90 Days		91-180 Days		181-365 Days		1-2 Years		2-5 Years		More than 5 Years	
	Coops & Family	Business	Coops & Family	Business	Coops & Family	Business	Coops & Family	Business	Coops & Family	Business	Coops & Family	Business
Level 1A	12.0%	14.0%	13.0%	15.0%	16.0%	18.0%	18.0%	20.0%	19.0%	21.0%	20.0%	22.0%
Level 1B	13.0%	15.0%	14.0%	16.0%	17.0%	19.0%	19.0%	21.0%	20.0%	22.0%	21.0%	23.0%
Level 1C	14.0%	16.0%	15.0%	17.0%	18.0%	20.0%	20.0%	22.0%	21.0%	23.0%	22.0%	24.0%
Level 2	16.0%	18.0%	18.0%	20.0%	20.0%	22.0%	22.0%	24.0%	24.0%	26.0%	25.0%	28.0%
Level 3	25.0%		26.0%		28.0%		30.0%		32.0%		35.0%	

Level 1A: Agriculture and fishing, light industry (consumer goods), traditional exports, extractive industries.
Level 1B: Public Transport, construction, agriculture commercialization, housing.
Level 1C: Hotels & Tourism, other.
Level 2: Service sectors, small and medium-enterprises, personal loans for consumer goods.
Level 3: Other sectors (personal credit for essential goods, etc.)

Structure of Interest Rates: Lending
January 1, 1989 - November 9, 1992

	Short-term									Long-term								
Period	Up to 90 Days			91-180 Days			181-365 Days			1-2 Years			2-3 Years			More than 3 Years		
	I	II	III	I	II	III	I	II	III	I	II	III	I	II	III	I	II	III
1/1/89--8/31/89	14.0%	18.0%	26.0%	15.0%	20.0%	28.0%	16.0%	22.0%	30.0%	22.0%	24.0%	32.0%	22.0%	25.0%	33.0%	22.0%	26.0%	34.0%
9/1/89-2/28/90	15.0%	20.0%	28.0%	16.0%	22.0%	30.0%	17.0%	24.0%	32.0%	22.0%	25.0%	33.0%	22.0%	26.0%	34.0%	22.0%	27.0%	35.0%
3/1/90-10/31/90	17.0%	20.0%	28.0%	17.5%	22.0%	30.0%	18.0%	24.0%	32.0%	22.0%	25.0%	33.0%	22.0%	26.0%	34.0%	22.0%	27.0%	35.0%
11/1/90-6/30/91	27.0%	30.0%	36.0%	27.5%	31.0%	37.0%	28.0%	32.0%	38.0%	31.0%	33.0%	40.0%	31.0%	34.0%	41.0%	31.0%	35.0%	42.0%
7/1/91-9/22/91	28.5%	34.0%	36.0%	29.0%	35.0%		30.0%	36.0%		32.0%	38.0%		32.0%	39.0%		32.0%	40.0%	
9/23/91-3/31/92	32.5%	36.0%	36.0%	33.5%	37.0%		34.5%	38.0%		35.0%	40.0%		35.0%	41.0%		35.0%	42.0%	
4/1/92-11/9/92	39.0%			40.0%			41.0%			42.0%			43.0%			44.0%		

1/1/89 - 6/30/91

Level I: Agriculture, Fishing, Commercialized Agriculture, Agriculture Cooperatives, Consumer goods and Food Industry, Electricity, Gas and Water
Level II: Industry, Extractive Industries, Construction, Public Works and Housing, Exports, Transport

Level III: Commerce, Restaurants and Hotels, Tourism, Cargo and Passenger Transport, Other Activities

7/1/91 - 3/31/92

Level I: Agriculture, Fishing, Commercial Agriculture, Cooperatives, Electricity, Gas, Water, Industry, Exports, Construction, Public Works and Housing, Transport
Level II: Transport of cargo and individuals, Commerce, Restaurants, Hotels, Tourism and other activities

Structure of Interest Rates: Lending
November 10, 1992 - May 3, 1993

<u>Short-term</u>	
Up to 180 Days	43.0$
181 - 365 Days	44.0%
<u>Medium/Long-term</u>	
1-3 Years	45.0%
More than 3 Years	46.0%

Structure of Interest Rates: Lending
May 4, 1993 - May 31, 1994

Lending rates established within a three percentage point maximum above the central bank rediscount ate.

Structure of Interest Rates: Lending
June 1, 1994

ree rates.

Central Bank Rediscount Rate

1/1/87 - 8/31/89	10.0%
9/1/89 - 2/28/90	12.0%
3/1/90 - 10/31/90	14.0%
11/1/90 - 9/22/91	28.0%
9/23/91 - 3/31/92	33.0%
4/1/92 - 11/9/92	39.0%
11/10/92	43.0%

C. BCM

Commercial banking is dominated by the BCM, one of two state-owned banks. BCM holds 70 percent of the assets in the commercial banking system and is the principal financier of the enterprise sector which is the principal source of formal employment in urban areas.. Fifty percent of BCM's loan portfolio is non-performing and is primarily to state enterprises. BCM, the bank with the largest credit ceiling, accounts for 65 percent of total commercial bank credit. Banking activity is segmented and uncompetitive. BCM has historically been associated with the state enterprise sector. Until recently, it was the only bank engaged in foreign exchange dealings which gave it a monopoly on trade activities. As a result of the reform process, BCM now competes with the private banks for foreign exchange business but still utilizes 97 percent of donor import support funds (which finance 75 percent of total imports). Private sector activities (both deposit taking and lending) now account for close to half of its business.

The process of separating the BM accounts presented a number of difficulties in respect of accounting for realized and unrealized losses and imbalances resulting from past practices in the combined institution. The first set of separated accounts for the period ending December 31, 1992 in effect assigned most of the problem accounts to the new BCM. The result was to create an illiquid, non-viable institution that was not able to comply with the prudential regulations which were about to be issued, covering all commercial banks. BCM was assigned with substantial non-performing loans to enterprises. These loans were made in the period 1987-1992, before BCM became a separate entity. While they were on BCM's balance sheet, BCM could not comply with the requirements of the banking regulations. The GRM used CPF that had been set aside at BM to repay pre-1988 non-performing loans of public enterprise. However, by mid-1993, it was still being adversely affected by the imbalance of foreign assets and liabilities that it inherited when it was created. It also pursued unrealistic expansion plans which were inappropriate for a commercial bank in its condition. In addition, BCM commenced operations with a poor portfolio of loans to state enterprises, for which provisions of at least 40 percent would be required.

Major problems were evident in the end-1992 summary balance sheet of BCM. Liabilities exceeded assets by MT 360 billion. This amount derived from three main causes: 1) the need to make provisions for bad loans of almost MT 200 billion, 2) an imbalance in the metical value of foreign exchange deposits and liabilities of some MT 260 billion (BCM's open foreign exchange position has become a more serious problem as the metical devalues), which was only partly compensated by assets in local currency (i.e., counterpart funds were not paid in); and 3) the failure of the GRM to pay in the initial capital of the bank of MT 30 billion. BCM had an overdraft with the central bank of about MT 200 billion and was not able to meet statutory reserve requirements on its local currency deposits. A major problem was the large volume of OIN on the balance sheet which represented in major part items in transit which had not yet been cleared, partly because of communication problems between different parts of the country, and weak accounting capacity in the head office and branches.

As part of the restructuring under the SERC, a mechanism was devised to: address the accounting imbalances in BCM so as to create a smaller but potentially viable bank that could comply with the prudential regulations; and recognize and deal with the losses arising from past practices in a manner that did not lead to increases in lendable resources available to BCM or other types of monetary expansion. BCM was required to adopt a series of tight financial and lending policies designed to reduce its exposure to clients with non-performing loans and strengthen its liquidity and to prepare a strategic plan with external support designed to strengthen its internal management and prepare the bank for privatization as soon as feasible.

The mechanism dealt separately with the underlying losses represented by the domestic currency and foreign currency imbalances. For rectifying the domestic currency imbalances, BM made use of the sterilized accounts it held of counterpart funds from donor import support programs (approximately MT 300 billion), which were held back from circulation as part of agreements under the IMF monetary programs. Approximately MT 200 billion were used to eliminate most of BCM's overdraft with BM. The transaction was equivalent to BM reimbursing BCM for the estimated provisions on the loan portfolio transferred and would not provide any additional lendable resources to BCM but would serve to downsize the balance sheet. The initial capital of BCM of MT 30 billion was paid in . MT 15 billion of this amount was retained by BCM as liquid assets to facilitate its payment function on behalf of government and was not available for lending. The balance was returned to BM as part of the needed increase in BCM's statutory reserves. BCM needed an additional amount of MT 50 billion to comply with statutory reserve requirements. The amount was transferred to the reserve account in BM from the counterpart funds account with a corresponding adjustment made to the shortfall amount on the assets side of BCM's balance sheet. As a result of the above transactions, the shortfall amount was reduced from MT 360 billion to about MT 80 billion.

However, BCM remains a major problem in the banking sector which significantly contributes to macroeconomic instability. As noted above, it is the major player in the banking system. In 1994, it exceeded its credit ceilings. During the first eight months of 1994, its overdraft position at the central bank went from 0 to MT 447 billion (it improved somewhat by the end of the year), credit increased by 50 percent, its liquidity decreased by 32 percent and OIN increased by 67 percent, particularly as a result of inter-branch debts which almost doubled. BCM has basically been recapitalized twice by donors: once to deal with pre-1987 debts and again in 1993 to deal with pre-1992 debts. It is expected that the GRM will announce the privatization of BCM in 1995 (and BPD in 1996).

D. Counterpart Funds

Counterpart funds have a major impact on financial sector operations in Mozambique. Donor import support funds, e.g., finance 75 percent of all of Mozambique's imports and generates significant levels of CPF. The amount of CPF to be generated in a given year consists of the local currency equivalent of aggregate grants (excluding emergency aid) and loan disbursements, less investment projects (which are considered as not giving rise to CPF). As foreign aid rapidly increased during the 1980's, the GRM was hard pressed to maintain adequate bookkeeping. The situation continued to deteriorate until 1991, when foreign technical assistance began to revamp the administration of counterpart funds and make the intersectoral aid flows more transparent. However, progress has been slow and the formation of a GRM technical unit in the Ministry of Finance, long planned, has yet to materialize, despite donor offers of support[1].

The most common way in which counterpart funds are generated is through an inflow of goods, which

[1] USAID escaped the worst effects of the deterioration in accounting for CPF because the program was reserved for private sector importers which were better managed than the state enterprises that dominated the economy and USAID had a separate account which made it easier to tell whether the money was being deposited.

may or may not be registered at BM. Upon arrival of goods, the enterprise is, in principle, obliged to pay the full value to BM in order to retrieve them from Customs. The CPF are then deposited into the MB-10 Treasury account at BM, which forms part of government deposits in the monetary survey and is used to finance budgetary operations. Food aid is valued at a special pass-through price, which is somewhat below the import parity price in order to allow the enterprise to earn a commercialization profit. For other goods, a value close to the import C.I.F. cost is used. In both cases, the valuation of the goods is agreed upon with the donor.

A second manner in which counterpart funds are generated is through an outright inflow of foreign exchange. These import support funds were, until recently, mainly from the World Bank's Economic Recovery Credits. In these cases, the transaction is registered at BM. The GRM initially retains control of the foreign exchange, which in the monetary survey appears as foreign exchange deposits in a special earmarked account, the fundos consignados. The funds are offered to the private sector to finance imports, in amounts consistent with macroeconomic targets. The private sector surrenders local currency in return for the foreign exchange and this counterpart is the shown as local currency deposits in the fundos consignados. Local currency deposits in this account were primarily used to reduce pre-1987 enterprise debt which the GRM had agreed to take over (they are also scheduled to be used to repay the ERC's when they become due). As noted above, CPF from donor import support funds were used to recapitalize BCM again in late 1993.

Beginning in 1992, there was a pronounced shift by donors toward untying their aid, in terms of import support funds. Aid disbursed as import support funds gradually increased. As the GRM budget is still heavily dependent on receiving donor support for its current operations, the GRM uses import support grants for the budget, while import support loans (e.g., the World Bank's ERC disbursements) are made available to the private sector. In the case where the GRM uses the funds, there is a decrease in the government funds foreign exchange account and an increase in the GRM's (freely usable) deposits.

Problems frequently occur with collection of CPF. The limited choice of well-managed enterprises and an anti-private sector bias led the GRM to choose public enterprises with liquidity problems. In order to facilitate the use of commodity aid in cases where enterprises did not have the capacity to pay the domestic value of commodities up front, the GRM previously used letras de tesouro (promissory notes). These were interest-bearing notes of varying maturities that remained outstanding until the enterprises were able to retire the notes by paying the counterpart funds. This was stopped in late 1992 after a large accumulation of counterpart fund arrears arose and it was realized that this put the GRM into financial operations with the private sector that should have been handled by the banking system. The letras de tesouro were replaced by cartas de garantia - letters of guarantee. With the cartas de garantia, commercial banks guaranteed the payment of counterpart funds to the GRM within a given time period that varied with the commodity in question. This was supposed to be designed for well-run enterprises that were strapped for liquidity to be able to obtain aid in kind, sell it, and only then pay the GRM. To keep track of the obligations, an off-balance sheet entry (conta cativa) was made for letters of guarantee. Upon payment, the amount was transferred to the GRM's regular deposits with BM (into the MB-10 account). However, the cartas de garantia were, in fact, more like letras de tesouro in that financial transactions were conducted without sufficient funds in place which may have been responsible -- in addition to communication problems between banks and delays in the clearing process -- for the significant increase in the interbank float which led to a simultaneous increase in OIN (and therefore net domestic assets) and in broad money. It appeared that: 1) items charged to OIN were misclassified; 2) there was a payment

5/4/93	45.0%
10/12/93	43.0%
6/1/94	55.0%
11/26/94	69.7%

flow problem between BM and the commercial banks; and 3) the commercial banks were hiding credit through implicit subsidies. Even with the Bank of Mozambique trying to keep a lid on credit expansion with restrictive credit policy, OIN invalidated the use of monetary policy instruments. Because of liquidity problems, the Treasury reinstituted letras de tesouro in 1994 due to a $150 million shortfall in the expected level of grants.

CPF are used for general current budgetary expenditures. The budget is drawn up based on pledges obtained at Consultative Group meetings. Because it is so dependent on foreign aid, amounts subsequently not collected hinder the GRM's ability properly execute the budget. In case of a shortfall, the GRM must take compensatory fiscal measures in order to maintain the target for domestic bank credit. By the same token, unplanned overdue amounts collected in a budget year represent windfalls, allowing the GRM, ceteris paribus, to improve its position with the banking system.

II. Performance

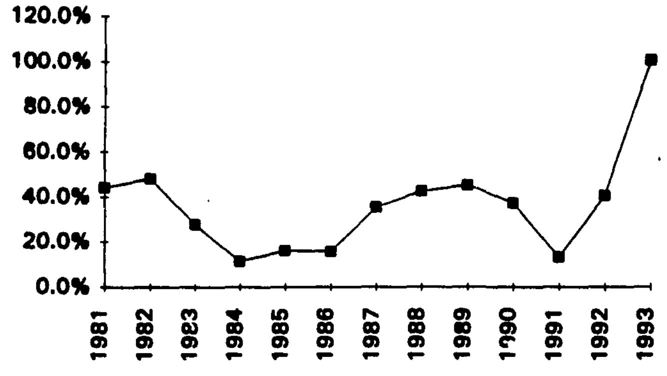
Monetary and credit developments during the early to mid-1980's were characterized by a tripling of domestic liquidity (money and quasi-money) and a near exhaustion of net foreign assets (from MT 8.1 billion in 1980 to MT 0.4 billion in 1986), reflecting an 18-fold increase in net credit to Government and a near tripling of credit to the economy (increasingly for financing enterprise operating losses rather than for new investment or normal working capital requirements). By 1985-1986, the pace of monetary and credit expansion slowed somewhat from earlier years as a degree of retrenchment set in. However, parallel markets had become extensive by this time and the use of foreign currencies, primarily the dollar and the rand, were supplanting the metical. A major overhang of domestic liquidity developed, with the ratio of broad money to GDP having risen to 67 percent in 1986.

Ratio of Money Supply to GDP

The monetary policies introduced under the ERP at the beginning of 1987 sought to rapidly absorb most of the liquidity overhang, foster a significant and sustained deceleration of inflation following the initial release of pent-up price pressures, improve the efficiency of credit use and stem the deterioration in the external accounts. The credit targets for 1987 aimed at allowing broad money to expand by only 45 percent, an amount estimated to slightly underfinance increases in transactions costs resulting from devaluation and official price rises and therefore, to reduce liquidity for parallel market transactions. Higher inflows of external resources were relied upon to help revive production levels (flexibility was provided by permitting substantial additional credit expansion beyond program limits to the extent it was supported by external concessional inflows to cover imports). New guidelines for credit appraisal were put in place that substituted commercial criteria for plan-based credit allocation (this was supposed to end, in principle, bank financing of enterprise losses). Monetary expansion was held to 49 percent in 1987 (far below the rise in nominal GDP). A sharp appreciation in the parallel market exchange rate also occurred combined with major devaluations of the official exchange rate.

The sizable absorption of excess liquidity in 1987 provided greater leeway in financial planning to facilitate the continuation of economic recovery and rehabilitation. The device of curbing inflation by underfinancing expected official price increases was retained in principle but gradually eased. In 1988, credit targets were established on the basis of a 43 percent growth in money supply (the actual increase was 54 percent), compared with a projected nominal GDP rise of 73 percent. In 1989, these projected rates were considerably closer at 30 percent for the money supply and 33 percent for GDP. The containment of government domestic financing requirements permitted the bulk of domestic credit expansion to be more directed to the economy proper and these amounts continued to be supplemented by externally-funded credit as well. Government recourse declined further in 1988 and turned negative in 1989. The rate of credit expansion to the economy increased by 42 percent in 1988 and 50 percent in 1989, even as the inflation rate, on an end of period basis, slowed to about 50 percent in 1988 and to 35 percent in 1989. Unclassified items, however, which had already begun to have an expansionary effect in 1987, increased by 840 percent in 1988.

Growth of Net Domestic Assets

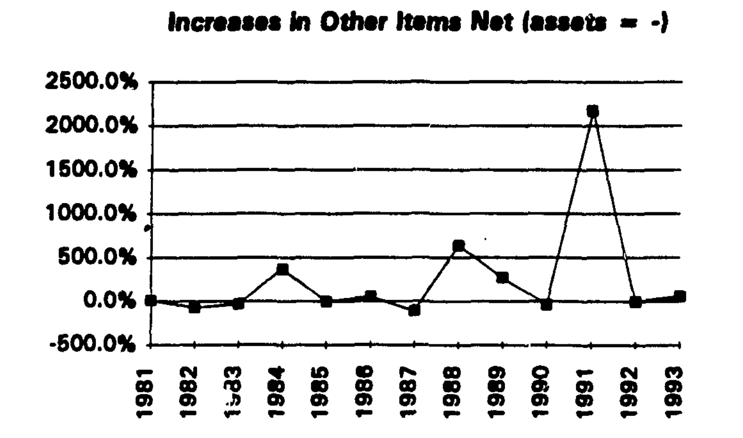


In 1991, BM adopted the net domestic assets (NDA) of the banking system as its main monetary policy target. This change was implemented because monetary policy control prior to 1991 had focused on credit ceilings but they were not tightly applied. Before 1991, ceilings were based upon domestically-sourced credit and there were several significant exemptions to the global credit ceilings. Given these drawbacks and the persistence of high inflation, the GRM moved to a system based on NDA rather than domestically-sourced credit. Under the IMF's program, quarterly benchmarks were set on NDA and net bank credit to government. The growth of NDA decelerated from 45 percent in 1989 to 37 percent in 1991. In 1992, NDA grew by 40 percent partly as a result of a rapid increase in the use of guaranteed checks. Deficiencies in communication between banks (and among branches of the same bank) as well as delays in the clearing process caused a large increase in the interbank float. This increase, in turn, resulted primarily from payee accounts being credited before payer accounts were debited, causing a simultaneous increase in other items net (and therefore NDA) and in broad money. NDA in 1992 was particularly influenced by a bunching up of foreign aid disbursements at the end of the year. Net credit to the Government grew by 235 percent, despite the GRM's policy to reduce its outstanding credit to the banking system. This was largely a result of the shortfall in nonproject grants for the budget.. Because much of the foreign aid for the economy only entered the country in the latter part of 1992 (and therefore couldn't be utilized that year), government lending funds increased by 133 percent over the year.

Medium and long-term foreign liabilities underwent a consolidation process in the context of the GRM's progress in data improvement. At the end of 1991, information from the Debt and Accounting Departments was cross-checked. As a result of this exercise, the stock of debt in the balance sheet of BM increased by MT 956 billion by the end of 1991, leading to a total increase of 98 percent..

Inflation remained a concern. An important source of macroeconomic instability, which has accounted for the continued high rates of inflation, stemmed from leakages in the banking sector. Other items net (OIN), mainly representing unidentified (non-performing loans of public enterprises) and transitory accounts in the banking sector, were large and growing rapidly. The effect of not controlling these items resulted in a rapid expansion of the assets of the banking sector and higher inflation than would be anticipated from other macroeconomic indicators.

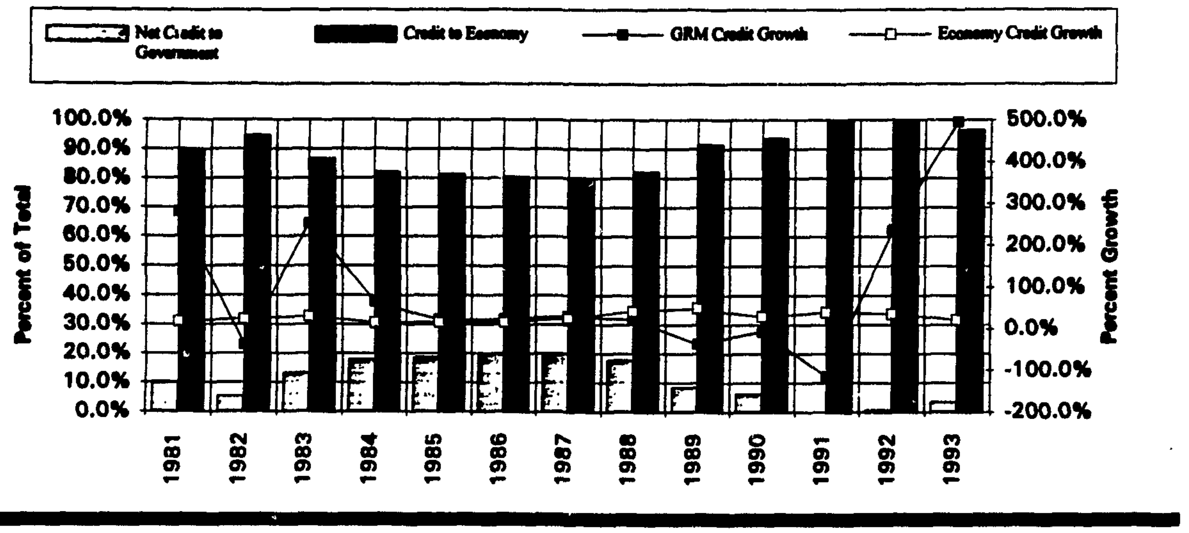
OIN increased by a huge amount in 1991, a 2,173 percent increase as BM and BCM were separated and accounts began to be identified. Large loan losses to state-owned enterprises appeared in OIN as a result and made up a substantial share of BCM's balance sheet (and, to a lesser extent, BPD). OIN marginally changed on a net basis (0.6 percent decrease) during 1992, influenced primarily by two large effects of similar magnitudes but opposite signs. On the one hand, the adjustment in the medium and long-term foreign liabilities resulted in a corresponding decrease in OIN. On the other hand, the interbank float increased (an increase in assets), partially offsetting the adjustment in medium and long-term foreign liabilities. However, OIN accounted for 80 percent of total assets and liabilities of the banking sector in 1992. This factor, i.e., the expansion in domestic credit, plus drought-related increases in food prices, led to increased inflation in 1992.



Money and quasi-money expanded by 59 percent in 1992 (compared to an inflation rate of 55 percent). The interbank float contributed some 26 percentage points to the increase in broad money. Also, net foreign assets (NFA) accumulated rapidly toward the end of the year because of the bunching up of foreign aid disbursements mentioned above. This resulted in a 28 percent increase in NFA (in dollar terms) over the end of 1991 and contributed about 13 percentage points to the growth of broad money. Currency in circulation accounted for 23 percent of broad money at the end of 1992 while time deposits reached only 9 percent.

Mozambique's performance in the financial area during 1993 was disappointing. The main reason behind this development was rapid growth in net domestic assets, which reflected, in part, the expansion of net credit to government but, most importantly, a number of expansionary factors in other items net. The money supply increased 79 percent, net credit to Government increased by 495 percent, and net domestic assets increased by 100 percent (a 70 percent in terms of beginning-period money compared with a target of 13 percent), resulting in a 44 percent inflation rate for the year. This occurred despite an encouraging price performance in the first half of 1993. These developments were primarily caused by a rapid expansion in OIN of the banking system (56 percent increase) and by a shortfall in the generation of counterpart funds. The authorities' main difficulty was in establishing monetary control in the face of significant movements in OIN. OIN increased rapidly partly due to implicit subsidies and an implicit expansion in credit to importers associated with the opening of letters of credit[2]. In addition, because of a large shortfall in foreign aid disbursements, the GRM borrowed from the banking system instead of reducing its indebtedness as programmed. Because of the late disbursement of foreign aid, nonproject counterpart fund financing available to the budget was less than expected (although difficulties in commercializing food aid also contributed to the shortfall). The GRM borrowed MT 51 billion from the banking system instead of repaying MT 64 billion as programmed. Although the overall budget deficit, before grants, was lower than programmed, this was in part obtained because of delays in the implementation of the peace process that forced the postponement of special expenditures associated with demobilization and elections to 1994.[3] Structural changes in the balance sheet of the banking system (especially regarding state-owned Banco de Mocambique) made it difficult for the authorities to monitor financial sector trends and ensure compliance with the program.[4]

Domestic Credit



Monetary performance in 1994 mirrored that of 1993. Although the target for net foreign assets was exceeded by $20 million and reserves increased by more than $45 million above the program target, the GRM was significantly out of compliance on several IMF program targets, although the situation

[2] In foreign exchange operations associated with letters of credit, BM used to charge the commercial banks the exchange rate of the day it was debited by the correspondent bank, while crediting counterpart funds to the government at the exchange rate of the day of the transaction (which was usually weeks or months after the debiting of the correspondent accounts of BM. This procedure entailed a subsidy to importers and a loss to BM. This was particularly marked in the second half of 1993 because of rapid exchange rate movements in that period and because of a bunching up of import support operations. The above practice was discontinued in late 1993.

[3] The special expenditures would have accounted for about 5 percent of GDP.

[4] For example, the constitution of loan loss provisions by BCM partly masked expansion in credit to the economy, the most important variable under central bank control. Efforts to clean up the balance sheet of BCM also had an impact on the timeliness of the monetary accounts. Although remedial measures were taken as soon as these problems were identified in late 1993, their impact on the monetary and credit aggregates took place in 1994.

improved dramatically during the last quarter of the year. By the end of December, the accumulated rate of inflation was 70.8 percent versus the program target of 30 percent (averaging 62.7 percent over the year). The primary cause was again an expansion in money and credit, particularly credit. Net domestic assets increased substantially above the program target, particularly OIN. The credit target was exceeded, with BCM, in particular, exceeding its credit limit. The GRM repaid some of its debt to the banking system but it was less than expected, which led to an increase in the fiscal deficit, before grants, of 30 percent of GDP (versus a target of 25 percent). Credit to the economy increased but was only about half of what was expected (part of the problem is that some of the credit to the economy is in OIN). An unexpected shortfall of $150 million in 1994 exacerbated the situation, forcing the GRM to reduce its level of repayment to the banking system.

The objective of reducing inflation through tight monetary policy, including the enforcement of credit ceilings, proved elusive in 1994. The end of year inflation rate for 1994 was 70.8 percent (well above the 30 percent program target), as broad money supply increased by 49 percent and credit to the economy increased by 65.5 percent. Inflation through the growth in money was driven in large part by the banks not adhering to credit ceilings and by an expansion in other items net (mentioned above). However, BM took stronger measures to control monetary supply in the last quarter of 1994 when it began to more strictly enforce credit ceilings and charge higher penalties.

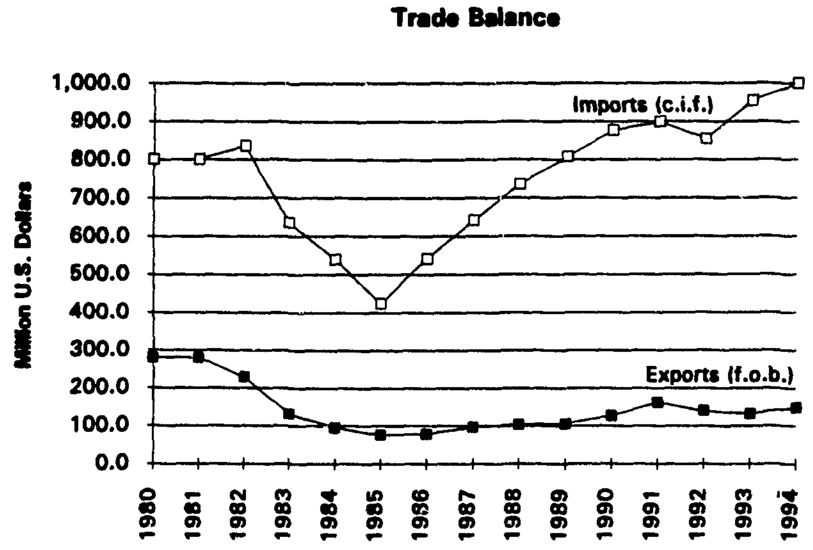
In response to this, the GRM announced in 1995 the following measures to control inflation: 1) rationalize public expenditures to avoid a situation whereby the state absorbs resources that should be used by the private sector; 2) make significant repayments to the banking sector to ensure adequate levels of credit to the private sector; 3) control monetary expansion on a quarterly basis by limiting net domestic assets in a manner consistent with economic growth and the reduction of inflation; 4) control monetary policy on a weekly basis by monitoring the increase in base money, net credit to government, external reserves of the central bank, and the exchange rate; and 5) maintain the rediscount rate of the central bank at a positive level in real terms in order to penalize banks that do not meet the required level of reserves.

Financial sector reform in 1995 will focus on: 1) open up the banking sector to diversify banking services (including the licensing of leasing activities) and increase the efficiency of banks; 2) accelerate the restructuring of the two state-owned banks in order to improve their efficiency in meeting the financing needs of the domestic economy; 3) promote credit for rural development, particularly at the local level, through the mobilization of financial resources; 4) stimulate and facilitate the transformation of informal sector banking activities into formal ones; and 5) stimulate domestic savings, particularly by ensuring an adequate rate of return, and creating financial instruments for the investment of this saving in economic development.

External Sector

I. International Transactions

The war, with its disruption of trade routes as well as its adverse impact on production, had a particularly negative effect on exports. At independence, Mozambique's exports covered only half its imports. Merchandise exports fell from $281 million in 1981 (Mozambique's best year in terms of export earnings, partly due to the purchase of crude oil at favorable prices which they then refined and sold the derivatives to other countries) to only $79 million in 1986. The total value of imports



also declined to a low in the mid-1980's, although consumer goods imports were inflated by purchases and emergency aid deliveries of food, from $801 million in 1981 to $424 million in 1985 before increasing to $543 million in 1986. Their fall and the containment of the trade deficit were part of the general economic decline. Meanwhile, receipts for transport services and migrant workers' remittances (traditionally leading sources of foreign exchange) both declined. Recruitment in the South African mines had been on a downward trend since independence and was little improved by the 1984 Nkomati Accord. Port and rail earnings were hit as South Africa undercut Mozambique's traffic rates and rebel activity put many of the country's transport links with the regions's landlocked states out of service. After the continuing deterioration in the early 1980's, Mozambique's external accounts were characterized in 1986 by extreme imbalances: the current account deficit, before grants, was $622 million (the services balance alone decreased from a surplus of $56 million in 1981 to a deficit of $159 million in 1986); the capital account deficit was $52 million; and international reserves were the equivalent of only 1.6 months of imports. In addition, Mozambique had an unmanageable debt service burden equivalent to almost 250 percent of exports of goods and services.

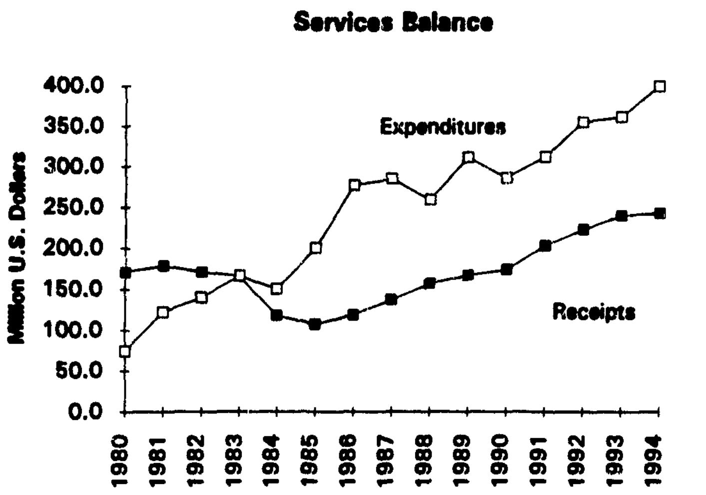
Implementation of the ERP in 1987 brought about a limited recovery in the external sector. Export and service receipts began increasing. Despite the partial export recovery, the trade deficit continued to widen from $545 million in 1987 to $751 million in 1990. The growth in exports after the start of the ERP was outstripped in absolute terms by the growth in imports. While the main contributing factors behind this development were the huge initial imbalances and the massive needs related to the rehabilitation program and economic recovery, the deteriorating trend in Mozambique's terms of trade clearly aggravated the situation. The terms of trade are estimated to have declined by an average of 6 percentage points per year from 1987-1989 and by nearly 7 percent in 1990.

In response to improved domestic incentives and rehabilitation efforts, exports increased from $97 million to $126 million in 1990 but the rate of improvement in nominal value terms slowed considerably because export prices decreased by about 3 percent per year. The recovery was led by traditional exports, primarily prawns and cashew nuts. However, manufactures assumed increasing importance in 1988-1989 as agricultural commodity prices weakened. Prawn and cashew nuts remained the key export items, accounting for about two-thirds of the total value of exports. Shipment of cashew nut exports, however, shrank in 1990, partly due to adverse weather and unfavorable international prices.

Since prevailing levels of imports were below the minimum necessary to provide the raw materials and spare parts to maintain production even at depressed levels, the ERP involved using external grants and credits to finance an increase in imports. Total imports increased at a substantial after an initial jump in 1986-1987. Food imports (mainly financed by food aid) remained at a level of $160-170 million per year. The growth of nonfood imports decreased from 20 percent in 1987 to 10 percent in 1990 partly because of the completion of restocking of spare parts and imported inputs and a levelling off of capital good imports in 1990. Imports of petroleum products cost about $60-70 million per year when crude oil prices were below $20 per barrel. The late 1990 surge in world oil prices led to a 35 percent increase in the oil import bill which added about $25 million to total import costs in 1990. The current account, after grants, and the overall deficits during the period 1987-1990 were held below their peak levels of 1986 (in U.S. dollar terms).

In the services account, receipts from transportation recovered very slowly, in part because the railways linking neighboring countries to Mozambique were frequently interrupted by sabotage or hampered by maintenance problems and equipment shortages. Workers' remittances, rose from $50 million in 1986 to $71 million per year in 1988-1990. Workers remittances declined to

$55 million in 1991 as the loss of remittances from workers returning from East Germany (estimated to be $18-20 million annually) was felt. Interest obligations, including those incurred in successive reschedulings with official creditors, were the main factor behind the movement in total service payments, generally exceeding other service payments as a group and roughly equaling total service earnings. The deficit in the services account ranged from $103 million in 1988 to $113 million in 1990.



Mozambique relied heavily on large inflows of foreign resources to finance its trade and service deficits. Estimates of private transfers, based on licenses for own-exchange imports and other information, were added to the external accounts starting in 1988.[1] These transfers amounted to $80-100 million per year, nearly matching imports of nonfood consumer goods. Receipts of unrequited official transfers[2] (mainly grants) continued to rise from $304 million in 1987 to $448 million in 1990. The current account deficit, after grants, declined from $389 million in 1987 to $318 million in 1990.

Loan disbursements, which amounted to about $285 million in 1986-1987, declined to about $230 million in 1988-1989. Estimates of direct foreign investment were incorporated into the balance of payments in 1990. Private capital inflows were low, although a significant increase in direct investment was registered since 1991 (however, this is from a relatively low base - from $6 million in 1987 to only $32 million in 1993). Between 1985 and March 1993, the GRM approved 147 projects worth $602 million, of which 22 projects were authorized during 1992, with a total direct foreign investment value of $58.4 million (less than half was actually invested). The value of investment projects in process for the period from 1985-1993 was $529 million. The principal investor in Mozambique is the United Kingdom (largely because of the Lonrho investments), followed by South Africa and Portugal.

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1 These estimates partially reflected unrecorded and parallel market conversions by residents and visitors as well as official private transfers. They did not reflect private donations for emergency relief which were not included in the balance of payments estimates because of lack of adequate information.

2 Does not include technical assistance.

The overall balance of payments deficit amounted to about $400 million per year in the period 1988-1990. The bulk of the deficit was financed by debt relief in the context of the 1987 and 1990 Paris Club rescheduling accords and similar agreements with other official creditors.[3] Several official creditors (including Germany, France and the Netherlands) forgave all or part of the bilateral debt owed to them. Mozambique cleared $14.4 million of arrears by November 1990 on post cutoff date accumulated in 1989 pending the negotiation of a request to advance the cutoff date which ultimately was not granted. Net foreign assets declined slightly in 1989 and 1990 (following considerable increases in 1987 and 1988).

Foreign borrowing decreased significantly in 1991 to a level of $144 million but increased to $170 million in 1992 (well below the 1989-1990 levels). With the exception of the sharp drop in 1991, which is explained by delays in disbursements, the underlying lower level of external borrowing reflected a shift in external assistance from credit to grants by most bilateral creditors. Scheduled amortization payments during 1991-1992 average $352 million, a modest increase compared to 1990. The capital account deteriorated in 1991 to a deficit of $187.5 million and improved to a deficit level of $155.1 million in 1992.

Notwithstanding the positive performance of most external indicators in 1991, the drop in loan disbursements brought about an increase in the overall balance of payments deficit to a level of $458 million. This situation was reversed in 1992 with higher capital inflows resulting in a reduction in the overall balance of payments to $407 million, in spite of a higher current account deficit. As in the past, this deficit was financed by debt relief and by arrears related to reschedulings sought from non-Paris Club creditors. In addition, Mozambique increased its net foreign reserves by $12.7 million in 1991 and by $37.2 million in 1992. Gross international reserves increased from 3.7 in 1991 to 4.4 months of imports in 1992.

Mozambique's external accounts improved significantly during 1991, with the current account deficit, after grants, falling to $237 million. Merchandise exports increased by over 28 percent in 1991, reaching a level of $162.3 million. Merchandise imports increased by only 2.4 percent in 1991. The service balance decreased by 3 percent in 1991, largely as a result of the liberalization of the foreign exchange market.

During 1992, however, the country faced an exceptionally difficult year largely due to the drought and adverse external conditions. The current account deficit, after grants, however, remained stable at $239 million. The suspension of export contracts (primarily for textiles) to the former Soviet Union, a deterioration in the terms of trade and the drought brought about a 14 percent drop in merchandise exports to a level of $139.3 million. Despite these problems, there were increases in both value and volume of a number of export products including prawns, cashew nuts, cotton, minerals and fishery products. Merchandise imports decreased by 4.9 percent in 1992. The decrease in 1992 was largely because of the increase in drought-related

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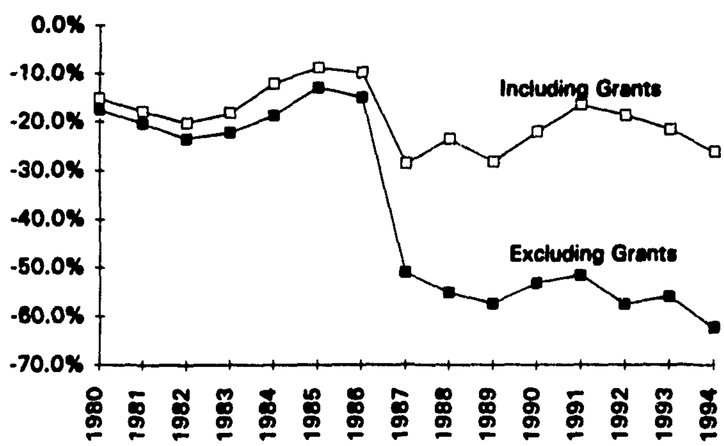
[3] The bulk of the deficit in 1989 was financed by an accumulation of arrears pending the 1990 agreements.

imports, i.e., the composition of imports changed dramatically to meet the needs of the drought. Service expenditures increased by almost 14 percent ($222.6 million) in 1992, largely as a result of higher interest payments resulting from previous reschedulings.

The low level of merchandise exports was partially offset by the services sector during 1991-1992, which increased to $223 million. The dynamism of this sector can mainly be explained by the effects of the substantial liberalization of the foreign exchange market. In the case of the transport sector, the signing of the Peace Accords led to an improved security situation. Transport earnings started to increase substantially in 1992, partly due to the donor response to the drought. After soft loan disbursements which have kept the basic capital account to modest net outflows, the payments deficit was made up by exceptional financing in the form of debt relief alternating with the amassing of debt arrears.

Current Account Deficit as % GDP



Foreign grants continue to cover over half of all of Mozambique's merchandise imports. Although the level of foreign grants reached an average annual level of $500 million during 1991-1992, disbursements fell short of pledges by donors in both years. More importantly, disbursements on account of drought relief in 1992 were about $104 million, indicating a reduction of over 21 percent in non-drought related aid compared to 1991. Grant aid is the principal item under net official transfers and this inflow dwarfs all other positive entries on the current account ($512 million in 1994).

The external current account deficit after grants reached $316 million in 1993 (85 percent of exports of goods and services). Merchandise exports plummeted to $132 million, partly due to bottlenecks in transporting agricultural exports. In response, the GRM began to implement additional measures to promote exports in the last quarter of 1993, e.g., further simplifying licensing procedures, eliminating remaining export tariffs and reducing import tariffs on inputs. At the same time, imports were $77 million less than programmed, reflecting a shortfall in foreign aid (most of which was due to the postponement of special programs to 1994 and a reduction in food aid because of the good harvest). Net foreign assets of the banking decreased by $46 million (compared with a programmed increase of $25 million). Gross foreign assets of the banking system were reduced to the equivalent of about 3.9 months of estimated 1994 imports (compared with a program target of 5.1 months).

The value of total exports increased by 13.4 percent in 1994. Mozambique exported $149.5 million worth of products in 1994 (well below the target level of $163 million). The average value of exports per quarter in 1994 was $37 million. Part of the reason for the failure to reach the target was the lack of money to finance production in export industries, bureaucratic export procedures and the uncertainty surrounding the elections. Prawns were the major export. Up to the end of September, prawns represented 40 percent of the value of all of Mozambican exports. The major buyers were Japan, Spain, Portugal, South Africa and Zimbabwe. Mozambique's second most important export was cashew nuts, which were mainly purchased by the U.S. and South Africa. However, the problems in cashew nut production resulting from the destruction caused by cyclone Nadia and the decline in processed cashew exports contributed to the less than expected level of exports in 1994. Other major exports were copra, cotton, citrus fruit, assorted minerals and textiles.

Success in stimulating private sector activities, providing commercial banking services and an adequate economic infrastructure will play a major role in increasing exports. Restoring an appropriate incentive framework is the GRM's principal strategy for the promotion of exports. The objective is to establish a neutral trade regime which would allow exporters access to inputs at world market prices and to export products at world market prices. To achieve these objectives, the GRM in 1995 plans to: 1) provide duty exemption regimes for exporters; 2) ensure exporters priority access to credit and foreign exchange; and 3) increase the role of the export promotion institute (PEX) and of business associations in export promotion.

Imports increased by 6.7 percent to $1.02 billion in 1994 (resulting in a trade deficit of $869 million), which contributed to the decline in the current account deficit, after grants, relative to GDP from 21.9 percent in 1993 to 20.8 percent in 1994. The share of import support funds (excluding food aid) declined from 50 percent in 1993 to 36 percent in 1994 of the total foreign financing whereas investment projects increased with the arrival of peace. It is unclear whether the reduction in import support funds was due to a fall in demand for these funds by the private sector. These changes have significant implications for domestic production as the economy is not yet generating enough foreign exchange to import the inputs required by domestic economic activity.

Mozambique remains the most aid dependent country in the world. Net disbursements of official development assistance in 1991 were equivalent to 69.2 percent of GDP, the highest ratio in the world. The international donor community provided more than $9 billion worth of support to the economy in grants, credits and debt relief from 1987-1994.

A. Major Exports

EXPORTS	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Million USD											
Total Exports, F.O.B.	95.7	76.6	79.1	97	103	105	126	162	139	132	149.5
Prawns											
Value	28.3	33.4	38.3	38.3	38.4	39.3	43.4	60.8	64.6	66.7	
Volume	4.4	5.4	5.4	5.4	4.9	4.9	5.2	7.6	7.7	8	
Unit Value	6432	6185	7093	7093	7837	8020	8346	8000	8390	8338	
Cashew Nuts						0					
Value	15.3	11.5	16.7	30.2	26.5	20.1	14.3	16	17.6	16.3	
Volume	4.1	3.1	3.1	6	6.8	6	4.5	3.8	5.6	5	
Unit Value	3732	3710	5387	5033	3897	3350	3178	4211	3143	3260	
Cotton											
Value	8	5.3	0.5	5.7	4.9	7.5	8.7	8.8	10.8	12.6	
Volume	5.9	4.7	0.8	3.8	4.4	4.9	5.9	6.1	11.3	12	
Unit Value	1356	1128	625	1500	1114	1531	1475	1443	956	1050	
Tea											
Value	10.8	2.4	1.3	0.4	0.6	0.1	0.5	0.8	0.2	0.6	
Volume	7.7	1.8	1.5	0.7	1.4	0.1	0.7	1.3	0.6	1.5	
Unit Value	1403	1333	867	571	429	1000	714	615	333	400	
Sugar											
Value	5.8	6.8	8.1	4.4	4.6	5.3	7.9	9.8	6.7	6	
Volume	16.4	16.8	19.5	10.4	11.6	12.9	17.9	24.8	16.6	15	
Unit Value	354	405	415	423	397	411	441	395	404	400	
Copra											
Value	1.9	5.1	2.1	3.3	4.5	1.9	2.6	4.7	4.2	6	
Volume	4.2	12.7	11.7	14.8	13.7	5.2	11.2	17.2	12.4	15	
Unit Value	452	402	179	223	328	365	232	273	339	400	
Citrus											
Value	3.2	3.1	2.2	2.5	1.9	3.3	1.9	1.9	1.1	1.1	
Volume	11	10.4	8.3	7.7	6.5	11.4	10.9	7.1	4.8	5	
Unit Value	291	298	265	325	292	289	174	268	229	220	
Petroleum											
Value	5.4	3.9	4	2.5	4.4	9.5	10.2	7.2	4.4	6	
Volume	22.8	16.6	16	9.2							
Unit Value	237	235	250	272							
Coal											
Value	0.5	0.3	0.3	0.6	0.4	0.4	0.4	0.2		0.3	

Volume	15.1	9.4	7.9	17.7	14.9	12	19	7.7	1.4	8	
Unit Value	33	32	38	34	27	33	21	26		38	

1. Manufacturing Exports

Mozambique inherited a relatively diverse industrial base, particularly in the manufacturing subsector. Mozambique has the potential to expand manufacturing exports given its diverse industrial base, cheap labor costs and high degree of underutilized capacity. Most manufacturing firms are partial and irregular exporters, with orders ranging from $10,000 - $100,000, with the exception of garment manufacturers and agro-processing firms which are 100 percent exporters. Export markets include primarily countries within the Preferential Trade Agreement (in Southern Africa), South Africa, OECD countries and the United States. The inability to access imported raw materials and intermediate inputs at world prices is one of the most important reasons for manufacturing firms lack of competitiveness in international markets. The impact of duties and customs charges on manufacturing costs can be considerable as Mozambican manufactured exports have a very high import content, averaging 65 percent for export products. The payment of duties and import charges increase the cost of imported inputs by an estimated 16-33 percent above world market prices. As a result, the manufacturing costs for these products is estimated at 10-22 percent over world prices. However, even if the payment of duties and taxes were to be avoided by smuggling the industrial inputs, the cost of smuggling is an additional cost for the exporter which would work just as an export tax.

A second major constraint is the difficulty manufacturing exporters have in getting quick access to short-term trade finance in foreign currency. This is a particularly serious constraint for most manufacturing firms in Mozambique as the current decline in output and sales led to severe shortages of working capital. Partly because of the underdeveloped status of the local banking system (see the Money and Banking section), commercial banks are reluctant to provide import finance based only on confirmed export letters of credit. In addition, quick access to foreign exchange is not always assured, given Mozambique's heavy dependence on external donor funds to finance imports, which are generally subject to lengthy administrative procedures.

2. Agro-industrial Exports

Agro-industrial exports (cashew, tea, sugar, cotton, etc.) were a major source of foreign exchange earnings in Mozambique during the colonial period. After independence, most agro-industrial processing firms were taken over or intervened by the state and grouped into large holdings.[4] By 1980-1981, cashew, tea and sugar still accounted for a large proportion of commodity exports (40 percent). However, the adverse impact of the war compounded by the poor performance of the state-managed factories led to a steady decline in production thereafter. The war severely disrupted rural marketing/production systems and destroyed installed capacity in strategic export areas. In addition, problems of obsolete capital equipment, low productivity and high levels of indebtedness attributable to the state management of these firms, further exacerbated the situation.

With the exception of cotton which is operating and expanding under a joint venture arrangement since the early 1990's, most agro-industrial exporting firms have been partially or fully paralyzed for several years. Already starved of working capital and lacking funds to make badly needed investments to replace obsolete plant and machinery, most firms are unable to operate. Moreover, stricter lending rules and uncertainty about the future of outstanding loans and wage arrears pending privatization have made access to bank credit very difficult. Significant restructuring, through privatization/rehabilitation would be required for most firms to resume or expand production.

In the case of sugar, large investments are required to restore irrigation systems and processing capacity. At present, the rehabilitation cost of the three state-owned factories is estimated at $170 million, which if implemented could expand output to 120,000 tons per year, more than enough to cover domestic needs and the export quota. However, in order to compete with imports in the domestic market, sugar factories will need to reduce production costs, which in the past few years have exceeded even the preferential quota prices.

In the case of tea, significant replanting of the orchard base is needed as well as large-scale rehabilitations. Only two of the twenty factories run by EMOCHA, the state holding company, are operational. Another three are to be rehabilitated with multilateral funds estimated at $40 million. EMOCHA is in the early stage of privatization and it is unlikely that the company could be sold as a single unit. The possibility of subdividing the 14,000 hectare estate is being considered.

In the case of the cashew industry, privatization/rehabilitation alone will not be sufficient to ensure the economic viability of investments unless existing distortionary trade policies are corrected. Prior to independence, Mozambique was the largest world producer of cashew with a production of over 200,000 tons and a capacity to process 150,000 tons of raw nuts per year. Current production is only about 35,000 tons per year versus an output potential of 80,000 tons and processing capacity of 40,000 tons per year. Depressed output levels reflect the impact of the war, aging orchards and unfavorable prices for raw nuts enforced to support an inefficient

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[4] For example, cashew factories fell under management of Caju de Mocambique and the tea estates under Emocha. The sugar estates were kept separate.

industry.

The cashew processing industry is inefficient due to the use of mechanized capital-intensive methods which are not competitive with major world producers like India and Brazil as well as the poor performance of state-run factories which are geographically not well located. In fact, cashew factories in Mozambique have been generating marginal or negative value added. The technical performance of cashew factories in Mozambique is extremely poor. This implies that the country could actually earn more foreign exchange by exporting raw nuts instead of kernels. To protect this inefficient industry, the farmgate price of raw nuts has been kept down both through low minimum prices and export restrictions on raw nuts. Lack of competition within the cashew market has meant that minimum prices effectively operate as fixed prices. The minimum farmgate price has average less than 20 percent of the border price over the past years, which is extremely low by international standards (e.g., in Tanzania the share is 50 percent of FOB and even this is considered to be highly inadequate). In 1993, only one private factory with a capacity of 6,000 tons was operating. Therefore, the GRM only allowed the export of surplus raw cashew output (about 22,000 tons). Export licenses were issued to six wholesale traders, who dominate the cashew market in Mozambique. As a result, these six traders and one factory made profits equivalent to four times the combined income of several hundred thousand farmers producing raw cashew nuts. Policies are clearly reducing incentives and incomes for cashew farmers, encouraging the rehabilitation of inefficient capital-intensive processing factories, and compromising export growth for the country as a whole. A shift toward semi-manual or manual techniques will probably be required if Mozambique's cashew processing is ever able to maximize foreign exchange earnings and farmers' incomes. During the end of 1994 and beginning of 1995, several policy measures were implemented which should help improve the incentive environment for cashew processing.

a. Fishing

Coastal and deep-sea resources were never exploited on a large scale in the colonial period but the sustainable catch is estimated at 500,000 tons of fish (of which 300,000 tons are anchovy and the rest mainly mackerel) and 14,000 tons of prawns. Since independence, prawns and shrimps have become major exports. Mozambique's own fishing fleet is limited but Japan, Spain, Portugal and South Africa are all present through either joint ventures or direct licensing schemes. The European Union has an agreement with Mozambique to catch 20,000 tons of fish and shellfish per year in return for a grant of $35.2 million for research and development. Japan has granted Mozambique $5 million to investigate unexploited areas in the 200 nautical mile zone off the Mozambican coast.

The total annual fish catch has shown a significant overall improvement since independence (the 1986 catch was double that of 1975). Much of this was the result of higher landings of species other than prawns but figures indicate that the 1988 shellfish catch was higher than that of 1975 (although lower than the best year in 1981). Yields generally declined from 1975-1979 and then began to recover, reaching a record level of 8,700 tons in 1981. Shellfish yields then declined before embarking on a steady growth path from 1986 onwards. A temporary ban on shrimp fishing in late 1990 and early 1991 and a ceiling on the 1991 catch were imposed to combat overexploitation. In 1992 the shellfish industry was temporarily hit by the effects early in the year of the Katina P oil spill off the southern Mozambican coast. With much of the traditional agricultural export sector depressed by the effects of the war, the fisheries sector has emerged as Mozambique's principal merchandise export category. New markets have developed and old ones reemerged, including an eager market for sea cucumbers in Hong Kong.

The State Secretariat of Fisheries presented its Master Plan at a conference in October 1994. The Plan responds to an urgent need for a strategy in the sector which emphasizes the role of the private sector. It also emphasizes the importance of the sector, which contributed 54 percent to total exports in 1993. It is expected that the Master Plan will have a significant effect on Mozambique's balance of payments, increasing the positive net amount from $40 million in 1993 to $84 million in 2005. An increase in employment of 40 percent (mainly artisanal) is anticipated over this period with significant participation of women in processing activities. The Plan envisions upgrading the currently non-viable industrial fleet and would promote pelagic fisheries outside the Sofala Bank and establish new fishing harbors. Attention will also be given to artisanal fisheries to improve production and reduce post-harvest losses.

3. Mineral Exports

Mineral exports have not so far earned significant sums of foreign exchange. In 1993, mineral exports accounted for only 3 percent of total exports. Production, which has considerable potential and has been generating interest among prospective investors, has been hindered by insecurity, obsolete equipment and transport problems. The most significant minerals are the pegmatite deposits in Zambezia province, which are now being mined for columbotantalite, beryl, mica, bismuth and semi-precious stones. Mozambique probably has the world's largest reserve of tantalite which is used in the electronics industry and for special steels. The large potential of tantalite may eventually make it Mozambique's most important mineral export. Tantalite mining at Murrua, originally supported by the former East Germany and Soviet Union, had to be abandoned during the war for security reasons. However, Russian and South African mining houses have been reexamining the deposits. An internationally competitive tax regime for the petroleum and mining sectors came into effect in 1993.

Sea salt production has increased steadily since independence and the output is now exported to neighboring countries. Small quantities of copper (with traces of gold), marble (Cabo Delgado province), garnet (Niassa province), kaolin (Nampula province), asbestos (Manica province) and bentonite (Maputo province) are also mined. Limestone is quarried for cement production. In April 1986 Lonrho negotiated an agreement to mine gold in Manica province near the Zimbabwean border, on a seam which the British company already mines in Zimbabwe. Official estimates of reserves are low but one South African company estimates that the area may hold one of the largest gold deposits in the world. Officially recorded production of gold has declined, although earnings have risen because of price increases. However, there is a large amount of gold smuggling, much of it allegedly routed through Tanzania. A U.S. firm, Edblow Resources, was given a 27 year concession in 1986 to explore and exploit titanium-bearing beach sand along 200 kilometers of coastline in Zambezia province. Another mineral sands project has been set up to exploit a deposit along the coast of Zambezia province which could yield up to $44 million per year in revenue. Graphite mining in the north is expanding. Kenmare Resources, an Irish company, is mining industrial grade graphite at Ancuabe and the European Investment Bank has agreed to a loan to a joint venture planning to produce 7,000 tons per year. There are also deposits of graphite in Tete and Nampula provinces. Apart from these minerals, the country's principal prospects are 100 million tons of high-quality iron ore in Tete province, which is intended eventually to be the basis for local iron and steel production using coal and electricity available locally. Large nepheline syenite reserves nearby could be used to produce aluminum. There are also deposits of bauxite in Maputo province (estimated at 4 million tons), apatite (Nampula province), and tin (Manica province).

4. Energy Exports

Mozambique has the potential to be a net energy exporter, selling hydro-electricity and coal. Exports of both electricity and petroleum products were virtually halted by the war.

The existence of large natural gas reserves in the Pande field in Inhambane province was known before independence. A survey by a British company estimated reserves at about 40 billion cubic meters. Early in 1992 the parastatal Empresa Nacional de Hidrocarbonetos (ENH) signed an agreement with South Africa's SASOL company to exploit the gas and export it through a 900 kilometer pipeline to the South African province of Transvaal. An original plan to pipe gas from Pande to South Africa was interrupted by Mozambican independence and the worsening political relations between Maputo and Pretoria. Renamo activity also hindered exploration and exploitation of the field, which many industry analysts believe has far greater reserves than that indicated by the British survey. An American firm, Enron, is in the process of completing an agreement with ENH to build the pipeline which it is estimated will provide Mozambique with $50 million of foreign exchange annually.

Tete province has known coal reserves of over 6 billion tons. The largest is Mucanha-Vuzi with 5 billion tons, half coking coal and half steam coal. Currently only the Moatize reserves are being exploited but production at two underground mines has in recent years been at levels less than 10 percent of design capacity. The main cause of very low coal output has been the war, which not only rendered mining insecure but also made transporting the coal to the ports extremely hazardous and costly. Although production rose after independence, output and exports have plummeted since the early 1980's. Production is possible but the chief constraint continues to be the cost of transporting the Moatize coal to port, which will require an investment in infrastructure of about $1.5 billion.

Moatize and other northern coal fields have considerable potential. One pre-feasibility study has claimed that Moatize could produce 9 million tons of saleable coal annually. In anticipation of improved security, the Ministry of Mineral Resources and Energy, along with the Brazilian Companhia Vale do Rio Doce, the UK's Lonrho and Trans Natal Coal, have undertaken preparatory studies as a basis for expanding existing operations.

Mozambique's natural resource endowment should provide the country with extremely cheap electricity and a substantial surplus for export. Civil war and mismanagement, however, have resulted in exports of electricity far short of capacity and very expensive domestic electricity. The huge Cahora Bassa dam on the Zambezi river, completed in 1974, was built by Portugal to supply electricity to South Africa. Portugal agreed to sell electricity at prices so low that the dam could never make a profit. At independence Frelimo refused to take responsibility for this "great white elephant". As a result, the Portuguese firm HCB runs the dam while Portugal remains responsible for paying off debts incurred in its construction. Mozambique now owns about 15 percent of HCB and will steadily receive a larger share until it owns the whole project in the year 2014. Cahora Bassa is linked to the Apollo substation between Johannesburg and Pretoria by a 1,400 kilometer (860 kilometers in Mozambique) 533 kilovolt direct current line, one of the longest in the world. Cahora Bassa has a 2,075 megawatt power station which should provide South Africa with 1,883 megawatts and leave about 150 megawatts for Mozambique.

After the signing of the Nkomati Accord with South Africa in 1984 there were tripartite talks between South Africa, Mozambique and Portugal which resulted in an agreement to increase payments to Portugal, make payments for the first time to Mozambique, provide more electricity to Mozambique and take joint action to protect power lines. However, Renamo sabotage continued and Mozambique derived little benefit from the agreement. By the end of the war, more than 1,500 of the 4,000 pylons had been destroyed by Renamo. The hydroelectric installations at the dam itself were, however, maintained in a good state of repair. Preparatory work on the line began in 1992 after the South African power utility, ESKOM, mediated an understanding with Renamo whereby rebels would cease attacks on the line. ESKOM has considerable interest in the scheme, as part of a plan for a regional power grid. A rehabilitation scheme for Cahora Bassa was negotiated in 1994 between Mozambique, South Africa, Portugal and other countries.

Other projects also use Cahora Bassa power. In 1980 Tete City and Moatize coal mine were linked to the power station and in 1984 a 1,000 kilometer line to link Quelimane, Mocuba and Nampula was completed. A line was built by East Germany from Nampula to Nacala in 1983. An agreement signed in April 1992 provides for electricity exports from Cahora Bassa to substations near Harare which could raise capacity utilization at the dam to about 20 percent. Once the Cahora Bassa projects are fully implemented, the average cost of power generation should fall and the marginal cost of electricity in the major centers will make it the lowest cost fuel for many consumers.

B. Direction of Trade

1. Imports

There was some diversification in Mozambique's trading partners after independence, with centrally-planned economies taking 16.7 percent of exports and providing 26.4 percent of imports by 1984. However, with the collapse of communism in the former Eastern bloc, the reunification of Germany and Mozambique's increasingly close ties to the West, this trend has reversed. The pattern of import origin, after implementation of the ERP, largely reflected the main sources of financial assistance since most imports were linked to foreign aid. In 1989-1990, more than 70 percent of imports were from OECD countries. The share of imports from OECD countries gradually declined from 1989 but remained high at 59.2 percent in 1992. Italy, the United Kingdom, France, the U.S. and the former Soviet Union were the major donors and suppliers, accounting for about 45 percent of total imports. With the country's membership of regional organizations such as SADC and PTA, imports from other African countries (excluding South Africa) substantially increased, doubling from 6.1 percent in 1985 to 12.2 percent in 1992. Portugal also remains an important supplier. After the improvement in political relations between Pretoria and Maputo, imports from South Africa, particularly consumer goods, rose dramatically from 11.7 percent of total imports in 1984 to 27 percent in 1992.

2. Exports

During 1985-1993, exports increasingly went to OECD countries which increased their share from 58 percent in 1985 to almost 70 percent in 1993. Exports to former centrally planned economies declined from 17 percent of total exports in 1985 to only 1.1 percent in 1993. Of the OECD countries in 1993, Spain was the largest recipient of Mozambican exports (29.5 percent), followed by the U.S. (13.3 percent), Portugal (13.2 percent), and Japan (11 percent). The other major recipients of Mozambican exports were primarily African countries, in particular, South Africa (15 percent) and Zimbabwe (6 percent).

II. External Debt

Immediately following independence, Mozambique was able to cover the large deficits on the current account with a variety of credits. However, Mozambique began defaulting as export volumes and prices fell after 1980 and as increased debt repayments became due. Mozambique called in its creditors in February 1984 and the following October agreement was reached with the Paris Club on the rescheduling agreement of some $300 million of bilateral official debt, including $50 million of arrears and 95 percent of debt service due between June 1984 and June 1985. Repayment, spread over 11 years, was to begin in 1990. In 1986, the debt service ratio was almost 250 percent.

Following the adoption of the ERP and the signing of an agreement with the IMF and World Bank in April 1987, further negotiations were entered into with creditors. A series of rescheduling agreements has since been reached with the London and Paris Clubs. In what was described at the time as "an unprecedented concession," $979 million of debt and arrears due to the Western nations and private bank creditors was made payable over 20 years in 1987, with a 10 year grace period and interest rates of less than 2 percent.

Mozambique owed its external creditors a total of about $4.4 billion by the end of 1989, including arrears of $1.8 billion in principal and interest. The country's external debt was owed primarily to official agencies, either directly or as guarantors. Multilateral institutions accounted for $392 million in 1989. Of the $3.6 billion owed to bilateral creditors, $1.6 billion was owed to creditors in OECD countries, about $1.4 billion to Eastern European countries (mainly the former Soviet Union), and the remainder to OPEC and other countries. Italy, France, Portugal, and the U.K. accounted for 80 percent of the debt owed to OECD countries in 1989, while Algeria and Brazil accounted for 60 percent and 80 percent, respectively, for the debt to OPEC and other countries. Almost all bilateral debt was of medium and long-term maturity. Previously rescheduled debt accounted for 80 percent of the total bilateral official debt.

Non-insured debt to commercial banks amounted to $350 million in 1989. About $311 million of the total was in arrears to London Club banks, of which 75 percent was owed to Brazilian, French and British banks. Another $30 million was owed to banks in South Africa, India, Panama and Zimbabwe. The term structure of commercial bank debt was quite different from that of the official debt, with short-term debt making up more than 50 percent of the total.

Western countries agreed to a three year debt rescheduling in June 1990, covering $700 million. Mozambique reached agreement with its Paris Club creditors to reschedule all arrears accumulated through May 1990 and 100 percent of eligible current maturities from June 1990 to December 1992 on Toronto terms. Mozambique also initiated negotiations with non-OECD bilateral creditors and, in some cases, obtained debt relief on even more concessional terms. The 1990 Paris Club accord allowed part of the late interest to be paid in the first semester of 1991.

Some progress was also made on debt reduction. France, Finland, Sweden, West Germany and the Netherlands had written off $340 million worth of debt by 1990. Bilateral rescheduling agreements were signed during 1991 with eight countries (including the U.S., U.K., France and Japan). In the same year, the World Bank approved a $10 million grant to help Mozambique to buy back $310 million in debt from 42 commercial banks at a 90 percent discount. The operation was completed in 1991. Also, a general agreement was signed providing for the transfer of debt owed to the former Soviet Union to the International Trade Finance (ITF) organization for later conversion into commercial assets.

The May 1987 agreement (regarding commercial bank debt) in principle with representatives of the London Club banks, which provided for debt rescheduling on extended but commercial terms, proved unworkable in view of Mozambique's insistence that it could not meet the implied debt service burden. The accord was superseded in 1990 by negotiations aimed at reaching a buyback arrangement. Resolution of the outstanding issues with commercial bank creditors (including the terms of buyback and full participation of the banks) could not be completed. Progress was made, however, in securing donor support in principle for the debt reduction operation. The GRM engaged an investment bank (Merrill Lynch) as financial advisor early in 1991 with the aim of reaching agreement with the London Club to eliminate most of the $311 million in commercial debt arrears.

Mozambique's external debt in 1991 was $5 billion. Of this, almost $4.1 billion was owed to bilateral creditors, $880 million to multilateral institutions, and roughly $22 million to commercial (unsecured) creditors. Arrears, totalling $583 million, were almost entirely related to rescheduling agreements being pursued with non-Paris Club creditors but also included $18.7 million in obligations to Paris Club creditors.[5] As a result of the 1990 Paris Club agreement (under Toronto terms), all pre-cutoff obligations with Paris Club countries through 1992 had been rescheduled. As a result, Mozambique was able to cover its financing gap through debt relief and through new arrears related to other rescheduling agreements not yet completed. During 1992, although scheduled debt service payments totaled over 386 percent of export receipts, actual debt payments were only about 21 percent of export receipts. Mozambique substantially reduced its external debt arrears during 1991-1992 through debt relief agreements reached with non-Paris Club creditors. In December 1991, a buyback operation financed entirely by external grants eliminated $204 million (over 60 percent of Mozambique's commercial debt). In addition, a rescheduling agreement with Brazil (including both official and commercial debt) eliminated over $470 million of arrears in 1992. As a result of the agreement, most remaining commercial arrears were eliminated and the commercial debt became guaranteed by the government.

In March, 1993, a new Paris Club agreement under enhanced concessions was reached, covering 1993 maturities and 1994 maturities (with an IMF arrangement in place). A total of $232 million was rescheduled or cancelled with this agreement in 1993. Eligible maturities were rescheduled

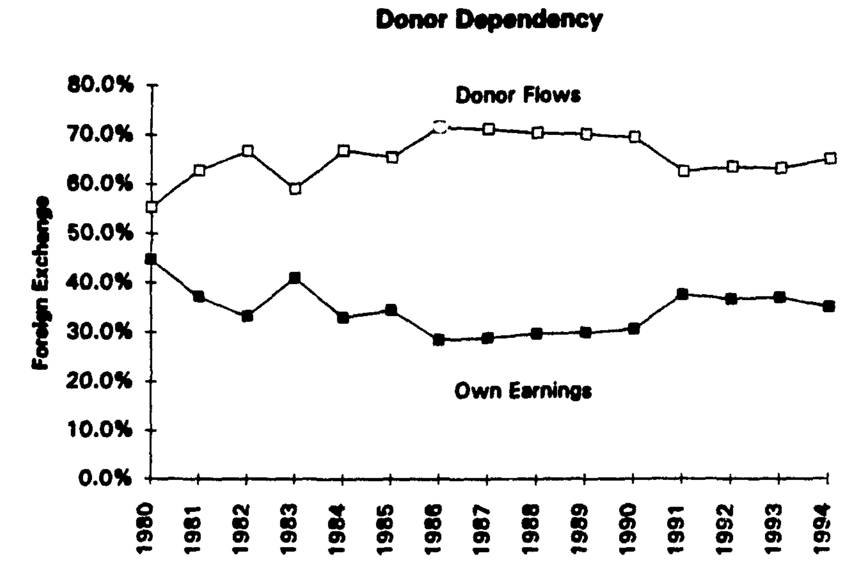
[5] All arrears to Paris Club countries were cleared by March, 1993.

under three options (all equivalent to a 50 percent discount in net present value terms). Although all pre-cutoff maturities were included in the rescheduling, obligations from ODA debts and from the 1990 Paris Club agreement were rescheduled in non-concessional terms and a non-concessional option was maintained for some creditors.

In the context of generally declining export earnings, external indebtedness has continued to grow. By 1992 Mozambique's external debt was equivalent to 495 percent of the country's GNP, a ratio higher than any other country in the world except Nicaragua (750 percent). Despite the concessional terms Mozambique has received in debt rescheduling agreements, debt servicing remains a heavy burden on the economy in its current state. The debt service ratio, before debt relief, was 133.4 percent and, after debt relief, 30.5 percent in 1993. During the 1990 CG in Paris, the World Bank endorsed the view that Mozambique cannot hope to achieve a viable balance of payments position unless a substantial portion of its debt is cancelled. British officials announced in 1991 that the U.K. would unilaterally implement Trinidad terms (two-thirds of the debt stock cut and the remainder scheduled over a 25 year period). Paris Club creditors were cajoled in March 1993 into a major deal to reduce Mozambique's debt by a range of means broadly in line with Trinidad terms, with some $180 million of debt forgiven. The GRM is continuing to lobby for further reductions of the debt.

III. Foreign Exchange

A. Donor Dependence



Mozambique is quite exceptional among developing economies in both its dependence on essential imports to sustain its population and maintain a certain level of production and in its reliance on foreign aid to provide the foreign exchange it needs to purchase those imports. Excluding emergency relief, imports from 1989-1991 were the equivalent in value of about 90 percent of GDP. Earnings from the exports of goods and services (principally prawns and cashew nuts, workers' remittances and transport services) have only been sufficient to finance a small proportion of total imports - less than 20 percent. The bulk of imports have been financed by bilateral and multilateral donors (primarily the World Bank and 12 major bilateral donors) through loans, grants and debt relief.

There has been a large and rapid increase in foreign aid since the mid-1980's. In 1991 donor funds comprising medium and long-term loans and grants, which accounted for about half of all foreign exchange inflows, totalled $650 million - an increase over 1985 of 70 percent (the equivalent of 50 percent of GDP or over 70 percent of imports). Although the bulk of donor funds (80 percent in 1991) were grants, foreign debt has accumulated to $5.6 billion in 1994. Over 90 percent of this debt is public debt or debt guaranteed by the GRM on behalf of public sector enterprises. Mozambique's exceptionally high level of import dependence and, in particular, its dependence on foreign aid to finance its imports means that efficient management of the foreign exchange regime is exceptionally important for the economy. This is especially evident as the thinness of the market is clearly seen when there are large shortages or supplies of donor funds.

B. Foreign Exchange Management

During the post-nationalization period (1977-1987) of centralized administration, foreign exchange was allocated through Ministries to enterprises which came under their supervision in accord with the GRM's economic and social priorities (rather than the enterprise's creditworthiness as in a market economy). The National Planning Commission was responsible for drawing up an annual foreign exchange budget reflecting these priorities and the Ministry of Trade issued import licenses accordingly. The Bank of Mozambique then issued foreign exchange licenses to import license holders subject to the availability of foreign exchange at the time. In 1984, a slight modification was made to this centralized system through the introduction of an export retention scheme which entitled exporters to retain a certain proportion of their foreign exchange earnings, initially for their own use.

In 1987 the GRM launched its Economic Recovery Program (ERP). Over the following two years a number of steps were taken including the decontrolling of some official prices, successive devaluations and the setting of regulatory tariffs which helped create a more market-oriented environment for the functioning of the foreign exchange management system. In 1988 two more schemes were introduced which, like the export retention scheme, gave importers automatic access to a certain amount of foreign exchange. In response to the big increase in foreign aid that occurred since 1986, a special Import Program Coordination Unit (GCPI) was set up to monitor the correct use of donor funds. Attached to the Ministry of Trade, it was in effect part of the existing centralized system of foreign exchange allocation through import licensing.

By mid-1989 prices and tariffs had become more market-based. Although the exchange rate was still overvalued, a policy of crawling peg devaluations were adopted and at the end of the year a basket of currencies was devised as a yardstick for the exchange rate. In October 1989 a first attempt was made to establish a limited Open General Import License scheme (called the System for the Non-administrative Allocation of Foreign Exchange or SNAAD). Firms wishing to import a certain limited range of products (mainly production inputs) were granted automatic entitlement to foreign exchange and an import license. The total demand for foreign exchange in the first year of operations was roughly $25-30 million (3 percent of total imports). The amount of untied donor funds (which were the sole source of foreign exchange supply for the SNAAD market) was insufficient and the flow of funds too irregular to sustain the market. As the range of products of the SNAAD system expanded over 1990-1991, demand rapidly exceeded supply and foreign exchange had to be allocated through a queuing process rather than through exchange rate adjustment. The market dried up early in 1991.

In October 1990 another attempt at reform was made when a secondary market for foreign exchange was opened. Under this scheme there were no restrictions on type of imports eligible for inclusion. Foreign exchange derived from service receipts, from surpluses of the export retention scheme and from nontraditional exports was used to supply the market. It remained small, however, amounting to only about $40-50 million in 1991 (about 7 percent of total donor funds). In December 1991 the export retention scheme was abolished which phased out that particular source of foreign exchange for the market. Neither of these schemes were a great success. As of mid-1991, SNAAD and the secondary market together only amounted to only 5-6 percent of merchandise imports. The reasons for their failure were mainly an overvalued exchange rate, the tying of donor funds and the insufficient and irregular availability of foreign exchange from untied funds.

In mid-1991 the official exchange rate was still significantly overvalued at 50 percent of the secondary market rate. By the end of 1991 the official market rate was 80 percent of the secondary market rate. By the end of 1991 there were two main sources of foreign exchange that were not tied to projects: own funds and donor funds (tied funds to which were attached 12 different sets of conditions regarding sourcing and procedures, and untied funds); and a multiplicity of foreign exchange allocation markets or windows (export retention, the SNAAD funded from untied funds, the Marketing Fund, the Medium and Small-scale Enterprise Fund, the secondary market incorporating an import entitlement scheme, and the official market funded from tied funds).

After five years of experimentation with partial schemes to establish a system for the non-administrative allocation of foreign exchange and a secondary foreign exchange market within a predominantly centralized system of foreign exchange management controlled by the Ministry of Finance and the Ministry of Trade (through its Import Program Coordination Unit), the GRM took the decision in agreement with the World Bank and the IMF to develop a new system for the management of foreign exchange. The immediate aim was to create a single large foreign exchange market incorporating all existing 'windows' for foreign exchange allocation (incorporating own funds, the import entitlement scheme, the SNAAD, and the existing secondary market), which would be regulated by a market-based exchange rate. This entailed a radical departure from a system of foreign exchange allocation that favored public enterprises and a few large private companies in certain sectors and categories of imports and that operated to meet economic and social priorities set by the state. The emphasis began to be placed on a system that facilitated access to foreign exchange for the business sector as a whole on the basis of creditworthiness, under which public interest priorities would be secured through budget subsidies to companies and public enterprises. In January 1992 BM (newly constituted as a central bank) took the first step by assuming full responsibility for foreign exchange management and took over the Ministry of Trade's responsibility for monitoring donors' tied funds. The issuing of import licenses as the main instrument of centrally-administered allocation was ended and were replaced by a Statement of Import Registration (BRI). The new system was inaugurated in April 1992. Authorized importers, whether industrial or importing companies, could now apply to commercial banks for foreign exchange for all types of goods. Although inter-bank contracts, import licensing and the issuing of BRI's are used in practice to preserve some control over foreign exchange allocation, the GRM has justified this practice because of the shortage and irregularity of supply of own funds and untied funds.

GRM management of foreign exchange has changed significantly over the past decade. Prior to the adoption of the ERP, the official value of the metical was extraordinarily overvalued. Today, the price of foreign exchange is more market-related. After the ERP, there were two important changes in the GRM foreign exchange allocation system. First, the GRM introduced a secondary market for foreign exchange in Maputo. It was initially in effect for foreign exchange transactions related to services but was subsequently expanded to include some imports and proceeds from nontraditional exports. This allowed foreign currencies to be exchanged at market-related rates at licensed foreign exchange bureaus. With the introduction of the secondary market, foreign exchange dealing was opened to private operators other than banks. Licenses were granted by the BM and initially were awarded to four established firms in the trade and tourism businesses rather than to new entrants seeking to handle foreign exchange transactions.

In April 1992, the GRM unified exchange rates, i.e., donor import support funds and export earnings were merged within the secondary market. Effectively, the secondary market is now the official exchange rate. The objective was to create a larger market whereby foreign currency would be allocated more through a market-related price. The results are apparent: since early 1993, the spread between the official and parallel markets has declined from about 25 percent to a current level of around 6-8 percent. The difference primarily represents transaction cost differences between using the official secondary market and the simpler parallel market.

The price of foreign exchange is Mozambique's most important price. Since October 1991, the price has been more market-related, i.e., influenced by demand and supply in the parallel market. In 1994, about $300 million (about 70 percent of Mozambique's free foreign exchange - defined as the difference between the count 's imports and predetermined uses such as donor-financed projects and debt service), came from donor balance of payments support. Much of this assistance is tied assistance which has important implications for the country's foreign exchange market and for GRM foreign exchange management. The heavy dependence on donors for balance of payments support exposes Mozambique to potentially large fluctuations in foreign exchange flows and the tightly tied assistance greatly reduces GRM flexibility to mange the external trade balance.

The secondary market of foreign currencies traded outside import support fund exchanges is a thin market (accounting for 21 percent of total transactions in 1994). The secondary market works for relatively small and routine transactions, e.g., purchase of travelers checks, etc. However, it does not provide ready access to foreign exchange for many private importers. Private importers who wish to import goods, especially capital goods, do not have ready access to foreign exchange. For many importers, the inability to access foreign exchange is directly related to the inability to access credit. Mozambique's financial system is still nascent and undergoing significant reform. As a result, the private sector had great difficulty in accessing commercial credit. Importers often have to use other means to access foreign exchange, including the parallel market. The magnitude of the parallel market is unknown but some observers estimate that transaction volumes averaged $60 million per month in 1994.

Given Mozambique's high dependency on donor aid funds to finance imports, free foreign exchange is not always readily available to meet exporters' import needs. From this perspective, export retention schemes could play a critical role as a complementary source of financing. In principle, export retention facilities are available for exporters (at variable rates) but implementation rules and regulations are unclear both for exporters and bankers, including BM. According to BM, exporting companies registered under the new investment code (whether foreign or local), are allowed to have foreign exchange retention accounts. A minimum amount of 30 percent of the firm's total foreign exchange earnings is supposed to be automatically granted[6]. However, some commercial bank representatives have indicated that all foreign exchange earnings have to be surrendered to the central bank and that no clear implementation guidelines for the retention scheme exist, although draft guidelines were issued by the central bank in September 1993.[7]

Many exporters are daunted by the lengthy and bureaucratic procedures in place to access donor funds for importers. Procedures differ, depending on the donor funds, which adds to the confusion and delays. Partly due to such procedural delays, import LOC's will have expired by the time the foreign exchange comes through. Confirming LOC's can take several months partly owing to procedural requirements and partly due to uncertainty on foreign exchange availability.

The central bank currently fixes daily the midpoint rate in its transactions based on the weighted average of the secondary market (MSC) of the previous day. The MSC (official) rate is then established within a two percentage point margin. The secondary market has increased its share of foreign exchange transactions over time. Foreign exchange transactions through the MSC increased to $147 million in 1994, a 38 percent increase over 1993.

Convergence of the official and parallel rates has proven difficult, partly because of Mozambique's extensive borders which, exacerbated by the current tax and customs regime, invites smuggling (particularly to and from South Africa). By operating on the parallel market, importers evade payment not only of tariffs but other taxes.

C. Performance

Prior to the adoption of the ERP in 1987, the official value of the metical was maintained at an artificially high level. Between 1976-1980, the currency (then the escudo) was held steady at around Escudo 32:$1. It drifted slowly downward to around MT 40:$1 by the end of 1986. By this time it had become evident that the metical was grossly overvalued at official rates. At the same time, a parallel (black) market rate of 50 times the official rate existed. One of the objectives of the ERP was to bring the official exchange rate to more realistic levels and to eliminate the de facto dual exchange rate system.

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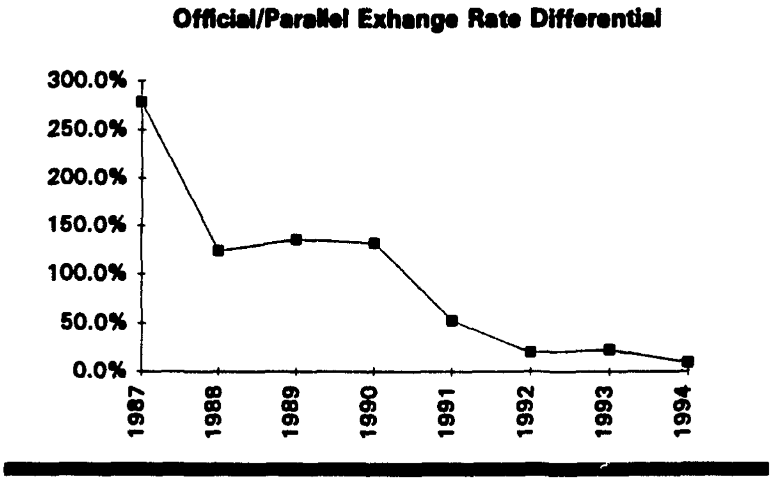
[6] For retention levels beyond this floor, the allowable percentage of retention is to be determined by the commercial banks on a case-by-case basis, with the percentage of retention determined by the firm's demonstrated need.

[7] Regulations regarding the implementation of export retention schemes are contained in the draft circular issued by BM - Circular No. 5/GGBM/93, which has not been made official. The retention rates provided for under this circular are set according to export value: 10 percent for exports up to $50,000, 15 percent for exports from $50,000 to $500,000; and 20 percent for exports above $1 million.

A comprehensive set of exchange rate, wage and price measures were taken during 1987-1989. The metical was devalued by a cumulative total of over 94 percent in foreign currency terms, from MT 39 to MT 820 by the end of 1989. The first steps toward realigning prices and restoring incentives were two large devaluations of the metical; by 80 percent in dollar terms in early 1987 and by another 50 percent in June of the same year. These moves had an immediate effect on both the official foreign exchange market and on the parallel market, where rates for the U.S. dollar exhibited a tendency to converge to the newly devalued official rate from about 1500-1800 Meticais per dollar to about 1200 by 1988. Though quite variable, the parallel rate remained at a level about 100-200 percent higher than the official rate through 1990. By mid-1991, the official rate had reached 1500 Meticais per dollar, with a parallel rate about 75 percent higher.



During 1991-1992, the metical continued to depreciate against all major foreign currencies, reflecting the liberalization in the foreign exchange market and the acceleration in domestic inflation. The introduction of the above-mentioned secondary market rate provided a convergence target for the official rate, which remained more appreciated but gradually caught up, ultimately unifying quotes in April 1992. During this transition, significant premia on parallel market rates against the U.S. dollar persisted but fell sharply to less than 20 percent in April 1992, reaching a post-independence low of 14 percent in August 1992. In terms of its nominal effective exchange rate, the metical fell by 49 percent during 1991-1992, while the real effective exchange rate fell by 22 percent. During the first six months of 1993, the secondary and parallel market rates continued to depreciate, while the official rate remained virtually stable through May but depreciated sharply in June to the secondary market levels (after a new calculation method was introduced). In September 1992, the Bank of Mozambique had changed the determination method for its rate, severing the link between the central bank rate and the secondary market rate (which gradually diverged). The situation was corrected in June 1993 with the midpoints of the central bank and secondary market rates at MT 3,511.6 = US$1 and MT 3,564.9 = US$1, respectively. The spread between the official and parallel markets decreased.

The official exchange rate was devalued by about 76 percent in real terms between 1986 and 1990 but foreign exchange and credit allocation remained administratively managed.. The foreign exchange system moved toward a market-based system and regular devaluations reduced the premium on the parallel exchange rate to less than 10 percent by the end of 1993 and averaged 13 percent during 1994. The metical depreciated by 81 percent against the dollar in 1993. It suffered in 1993 from the fact that the majority of operations in foreign exchange, particularly most purchases of foreign exchange associated with letters of credit, were not included in the calculation of the average exchange rate and therefore, were not used to determine the central bank rate. The Bank of Mozambique corrected this deficiency by charging commercial banks (and the commercial banks charging their clients) the exchange rate of the day in the debiting of the commercial bank/client account. The metical depreciated by 26 percent against the dollar in 1994. The metical depreciated gradually in nominal terms relative to the dollar over the course of 1994 but the effective exchange rate appreciated in real terms. The spread between the official and parallel rate declined from 19 percent in March to 10 percent in December 1994. This spread was explained in part by the evidence of transactions to avoid taxes and tariffs as well as to circumvent remaining official payments and capital transfer restrictions. It was also explained by the continued use of foreign currency as a store of value.

The Business and Investment Climate[1]

I. Introduction

The business environment in Mozambique poses serious constraints to private sector development. Among the reasons for this are the imposing regulatory burden facing enterprises, inefficiency in customs and port operations, and a poorly functioning financial system. Overall, the adverse business climate in Mozambique is essentially rooted in the dominance of an interventionist approach on the part of the state, which seeks to control rather than facilitate private sector activities. Unfortunately, this is exacerbated by the state's lack of capacity to implement complex and excessively demanding regulations, rendering the system ineffective and inefficient.

Regulations in Mozambique are numerous and excessively demanding. Even minor transactions require notarized signatures, special paper and stamp taxes. Many repetitive steps are required before firms can establish themselves and undertake business operations. A number of registrations, permits and licenses must be obtained from a variety of government agencies. These requirements frequently complicate entry and exit and inhibit competition. Regulations lack transparency and procedures are not standardized or automatic. Consequently, very few private (and even government entities) have the full picture in respect of all the steps needed to complete a specific transaction. Regulations are frequently enforced on a discretionary basis and adds unwarranted additional costs. The GRM's limited capacity to administer complex and cumbersome procedures further adds to the costs of doing business in Mozambique. Delayed responses by government agencies to applications and authorizations are a major obstacle to operations. On the other hand, the enforcement of demanding regulations carries a very high opportunity cost for the state which could be using scarce resources in more productive ways.

II. Regulatory and Institutional Constraints

A. Establishing a Business

In order to establish a business in Mozambique a company must meet registration, permit and licensing requirements which can constitute a bureaucratic and financial burden as well as a disincentive for private investment, particularly foreign investment. Procedures for the registration of a company, as defined under the commercial code, are standard but expensive in comparison with other countries. A company must first register at the Commercial Registry and then at a local tax office of the Ministry of Finance. The requirement to publish the articles of company association in the official gazette may take several months because of limited available space. Most importantly, the cost of registration is high - typically 1.8 percent of the share

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[1] This section is derived from a recent World Bank Report, "Mozambique: Impediments to Industrial Recovery," Macro, Industry, and Finance Division, Southern Africa Department, February 1995.

capital when the registration fee and stamp duties are included. The GRM is currently reviewing the possibility of lowering registration costs. In this regard, Mozambique could follow the example of other countries, e.g., Malaysia, where company registration is based on standard formats and subject to flat registration fees, equivalent to less than 0.1 percent of share capital.

In the absence of standardized forms, applications may be turned down or delayed if the company statutes do not comply with the Registry's interpretation of the commercial code.[2] Further delays may also be incurred because of the small number of notaries (eight in Maputo) and limited space available in the official newspaper.

In addition, companies which have to be established under the investment code must obtain an authorization from the Center for Promotion of Investment (CPI) and register their investment at the Ministry of Finance and Bank of Mozambique in order to access fiscal incentives and the right to remit profits. While each of these steps involve a great deal of time and paperwork, the procedures to obtain an investment authorization by CPI are a bureaucratic hurdle for investors.

Company Registration Steps
Under the Commercial Code:
Notary Public, Certificate of the Formation of the Company
Registration in the Commercial Registry
Publication of Articles of Association in the Boletim da Republica
Registration at the Tax Office of the Ministry of Finance
Under the Investment Code (for investments authorized under the code):
Authorization of investment issued by CPI
Registration of direct investment at the Bank of Mozambique
Registration of indirect investment at the Bank of Mozambique

[2] The commercial code dates from colonial times.

Costs of Registering a Company at the Commercial Registry

Share Capital	Fees to Registry	Other	Notary Fees	Total
< MT 1 million	3%	0.2%	3.6%	6.8%
MT 1-5 million	$12 + 3% on the excess over MT 1 million	0.2%	2.4%	5.6%
MT 5-10 million	$50 + 2% on the excess over MT 5 million	0.2%	2.4%	4.6%
MT 10-20 million	$85 + 1.5% on the excess over MT 10 million	0.2%	1.2%	2.9%
> MT 20 million	$130 + 1.0% on the excess over MT 20 million	0.2%	0.6%	1.8%

B. Investment authorizations by CPI

The application procedures to obtain an investment authorization, as dictated by the investment law, are complicated and costly. Moreover, the CPI has added several requirements for the submission of investment applications, in addition to the those stipulated under Article 10 of the code, (see Box 4.2). These include (I) a five year financial forecast indicating revenue, profits and cash flows; (ii) a market feasibility study containing detailed technical plans; and (iii) proof that the minimum share capital has been paid to the commercial registry. In addition, a bank guarantee equivalent to 30 percent of the value of investment has been required in some instances where the allocation of land has been involved, making the process even more difficult and costly. Finally a fee equivalent to 0.5 percent of the investment, up US$50,000, must be paid to CPI once the investment is approved.

Clearly, the documentation required to process the application is excessive, for the most part unnecessary, and more appropriate for a credit institution than a promotion agency. The investment application is too long by the time financial forecasts and feasibility studies are incorporated. The CPI has little capacity to use the information received in any meaningful way (e.g., to undertake analyses of financial statements, project evaluation nor to carry out policing activities of potential investors). The inclusion of a bank guarantee as an additional requirement poses a serious constraint on investment, both because it involves a steep financial cost for the investor and because banks are unlikely to take equity risks on top of credit risks.

Box 4.2: Investment Code - Decree No. 14/93, Article 10 (Documentation Required to Accompany Applications)

- Bank references for each prospective investor
- Documents proving the legal existence of prospective corporate investor
- Accounts of previous financial year, as well as existing catalogues, brochures etc.
- Curriculum vitae and certificate of criminal record of each proponent
- Proposed articles of association of the company
- Any proposed alteration to the articles of association if company already exists
- Agreement or contract of association between parties of company, if applicable
- Evaluation study of environmental impact of project

An internal report with recommendations for the Evaluation Committee is prepared by the CPI in a period of 30 days after submission of the application. The committee consists of high-level representatives (Vice-Ministers and National Directors) from the central and line ministries as well as from the Bank of Mozambique. Despite the fact that investment approvals are granted by this high-level committee, there have been instances where the fiscal package approved by the CPI has reportedly been invalidated by the Ministry of Finance at a later stage, defeating the whole purpose of going through the process.

The investment authorization by CPI is yet another bureaucratic step which neither eliminates nor facilitates the completion of additional requirements imposed upon investors in order to establish a business. Companies are still required to complete a range of additional steps including registration at the commercial registry, publication of registration in the government gazette, registering with the local tax authorities, obtaining licenses, etc. The CPI is currently set up to screen investment proposals and is doing little to promote investment. Too much emphasis is placed on project evaluation, to no obvious advantage, while little or no contact is being developed with prospective investors.[3]

C. Licensing

The registration process can be costly and lengthy but the main complaints of business are related to the licensing system. After complying with the registration procedures described above, a company must obtain a number of licenses from various ministries in order to operate legally in Mozambique. Typically, these include a license from the relevant supervisory ministry

[3] According to the CPI, although stipulated by the law, criminal records in practice are not required.

(which can include more than one depending on the activity) and separate importer/exporter or trading licenses from the Ministry of commerce. Most licenses have to be renewed every year and involve often repetitive and unnecessary documentary requirements (e.g., criminal records, educational degrees).

Box 4.3: Requirements for License the Ministry of Industry & Energy

- Articles of company association
- Notarized photocopies of personal ID documents
- Criminal record issued by the Ministry of Justice of the investor's country
- Certification of residence and good standing by the relevant municipality
- Fiscal stamp of Mt 10,000
- Technical plans of proposed installations
- Approval by the local administrative authority (generally the provincial governor)
- Notarized photocopies of educational degrees

If new partners enters the company a new license must be obtained which requires:

- Notarized photocopies of title to property or evidence of rental payments
- Photocopies of latest receipts of water, electricity bills of the company
- Notarized certification of tax payments from the Ministry of Finance
- Notarized criminal records
- Notarized copies of two ID cards

Requirements for Importer License from the Ministry of Commerce

- Copy of company registration
- Letter from the Ministry of Finance stating that no tax payments are outstanding
- A bank reference letter
- A letter from Customs certifying no duty payments are outstanding
- Specification of type (class) of items to be imported
- Nominal fee determined according to the type of imports

Moreover, licenses are often being used to restrict the number of firms operating in a particular sector and therefore constitute a barrier to entry of potential competitors. A high premium is paid to buy operating or incumbent firms already holding approved licenses. License fees can be expensive as is the case of mining, where payment for mineral rights are about 100 times higher than those in the Ivory Coast.

Draft legislation is being prepared with the aim of harmonizing and simplifying the licensing regime from the various ministries. While the standardization of requirements may be considered a positive step, the existence of a licensing system in itself does not render obvious

[4] A company wishing to build fishing boats, for example, must obtain a license from the Ministry of Industry, the of Transport and from the Secretary of State of Fisheries.

benefits but rather adds to the cost of doing business in Mozambique. Moreover, the draft foresees that license applications be published in the Boletim da Republica prior to approval in order to allow objections from affected third parties. Clearly, this would be a way of formalizing the role of licenses as an instrument to inhibit competition (in order to favor specific firms) which could only have a detrimental impact both on employment and output.

In sum, the climate for private investment is being rendered less attractive than it would otherwise be by cumbersome applications procedures, and by the uncertainty that inevitably follows from discretionary decision-making. Streamlining and the elimination of unnecessary procedures and requirements are urgently needed if Mozambique is to be more successful in attracting private investment. Although investments authorized by the CPI amounted to US$870 million, from 1985 to September 1994, only just over US $160 million are under implementation (including US$60 million in foreign investment). About US$300 million approved during 1985-90 never reached the implementation stage.

It is being recommended that a flat fee be levied for company registration comparable with international practices. The requirement to obtain investment authorization certificates by the CPI should be eliminated and eligibility to access any tax breaks/concessions should be made automatic based on the investment registration (see below). Finally, operating licenses issued by the various supervisory ministries should be restricted to activities involving the exploitation of natural (exhaustible) resources, e.g. fishing and mining.

D. Operating Regulations

While the removal of restrictions to company entry are extremely important, regulations governing business operations are just as relevant to attract private investment. Key regulations include the labor and tax laws and existing investment incentives such as the ability to remit profits.

E. Labor regulations

Labor related regulations are extremely cumbersome, and for companies with large number of employees, they involve a heavy administrative burden. For example, all overtime must be reported to the Ministry of Labor within fifteen days of its occurrence. Labor contracts must be presented to the Ministry of Labor for approval every six months indicating changes in wages and payment of any bonuses. This is a costly task for companies any time that they adjust wages, and also discourages any productivity-linked payments. In addition, a full payroll statement signed by the employer must be sent monthly to the Ministry. Finally, monthly inspections are also carried out, during which it is ensured that the company's working hours are advertised on the walls.

In cases of unilateral termination of contracts, a severance payment to the worker is required, except when dismissal is justified on disciplinary grounds. The labor law stipulates three months of current salary for workers employed from six months to three years, and three months of current salary for every two years when the worker has been employed for over three years. In addition, the employer is required to give three months advance notice to the worker and the Ministry of Labor before laying-off a worker, or else pay the three months as severance. These terms are quite unfavorable in terms of ensuing costs, e.g., compared with other developing countries, and tend to promote inefficiency. Because severance payments depend on tenure, employers have an incentive either to ensure a high turnover of young workers or not to dismiss workers to avoid severance payments altogether. Under the latter, labor is effectively treated as a fixed cost and becomes unresponsive to market conditions. Moreover, on-the-job training and productivity linked wage increases tend to be discouraged, negatively affecting labor efficiency.

There is a general consensus that the labor law should to be revised. The current law written in 1985 is outdated and irrelevant in a non-command economy. Specific areas requiring attention include the need for flexible contracts, streamlined procedures for disciplinary dismissal and for a revision of the formula used for severance payments. In this regard, consideration should be given to the introduction of an upper limit to the total severance payable, (e.g., up to six to twelve months salary, following the example of countries with more flexible labor regulations).

F. Tax regulations

Registered companies in Mozambique are obliged to pay a number of direct (corporate tax, payroll tax) and indirect taxes (consumption, turnover tax, import duties etc.) plus assorted stamp duties associated with specific transactions. While progress has been made in rationalizing the tax regime, through reductions in the level and number of tax rates, the tax burden in Mozambique remains quite heavy and constitutes a strong incentive for informal sector activities, particularly for import smuggling as discussed in earlier chapters.

According to the latest tax package adopted in December 1993, the corporate tax in Mozambique has been reduced from 50 percent to 35-45 percent, depending on the type of economic activity. Provisions have also been made to reduce import duties on raw materials and to exempt industrial inputs from the turnover tax. However, the level of statutory indirect taxes, particularly on imported consumer goods, remains too high and provides a strong incentive for tax evasion. While the level on import duty alone is not excessive, 35 percent, the total import tax on consumer goods amounts to a minimum of 62.5 percent when other taxes are included. In addition, any move through the distribution chain adds a further 10 percent to the sale price.

Mozambique Tax Regime

Type of Tax	Income Tax*	Turnover Tax	Consumption. Taxes	Stamp Taxes	Payroll Taxes	Customs Fee	Import Duties
Administrative costs	Yearly External Audits. Paid twice a year.	Detailed accounting for each product or service. Numerous exemptions	Paid once at factory gate or at border.	Seal and various stamp taxes.	a) ISS b) Tax on salary income. Company must retain and keep accounting.	Paid once at border.	Paid once at border.
Financial Cost	35-45 % net profits	ad-valorem (5%-10%)	ad-valorem (20-150%)	small lump sums	ISS 4%	2.5 % of c.i.f. value	(5-35%) value

* This rate is applicable to companies in group A. This group includes large companies with sales in excess of Mt 25 million, foreign investors, state owned companies and limited partnerships.

Moreover, according to the companies interviewed, the payment of taxes involves a great deal of paper work and can be very time consuming (e.g., special forms for the turnover tax must be submitted monthly in five copies for each sale/product unit). Stamp and seal taxes (caribo), required to legitimize a number of carimbo transitions, are considered a major nuisance. While the monetary cost of the stamp tax is modest (e.g., Mt 100 each), compliance costs are high as they involve time and resources for both private and government agents: the "carimbo tax" is an example (see Box 4.4). More serious problems arise from the methods used to calculate stamp duty liabilities for specific transactions. For example stamp duties payable for notarization of collateral in credit transactions can be as high as 7 percent of the value of the asset. The value of the stamp[56] tax is determined according to the size of the project, the sector, the number of pages per document, etc.

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[5] Including a minimum consumption tax (20%), turnover tax (5%) and customs handling fee (2.5%).

[6] There are other taxes not mentioned here such as fuel, tourism, and vehicle taxes.

Box 4.4: The Carimbo Tax

The carimbo, or seal stamp is an example of excessive bureaucracy which can cost companies more in time and resources than the revenues actually collected. The seal tax is required on all sales invoices which must be pre-stamped at the Ministry of Finance. Some companies have reportedly hired a full time clerk for the sole purpose of carrying out this stamping procedures at the Ministry. In addition, companies must send a photocopy to the Ministry of every single invoice issued. One company, e.g., was required to send over 500 photocopies a day to the Ministry of Finance.

Seal stamps are also on commercial calendars, movie tickets, playing cards, tickets for games, raffles, and rental agreements for housing. For example, promotional calendars must be stamped at the regional office of the Ministry of Finance. The calendars are counted and measured by a tax officer since the tax value is a function of the surface area of the item to be stamped. Each item is then physically stamped. For a company distributing thousands of promotional calendars this could entail tying up a truck, driver, and a clerk for over a day, a cost much greater than the $50 paid in taxes. If the calendars are distributed without the appropriate seal, a fine equivalent to five times the amount of the tax is payable by the company.

The high level of indirect taxation creates incentives for negotiation of ad-hoc exemptions with the Ministry of Finance. This is also the case of many tax exemptions/reductions provided under the tax law (e.g., turnover tax on "industrial" inputs, import duty reductions) which are not written in the tax code. Even in the case of tax breaks provided under the investment code, companies must undertake additional paperwork to make the benefits effective, despite the fact that the investment registration at the Ministry of Finance already indicates eligibility.

G. Fiscal incentives

The new investment code, enacted in July 1993, defines fiscal benefits for investment authorized by the CPI as well as the eligibility criteria to access such incentives. A positive feature of the code is that it provides equal treatment to local and foreign investors. However, small investments are discriminated as the limit for eligibility is US$15,000 for local investment and US$50,000 for foreign investment.

Under the code, raw materials/inputs used for exportation and all materials, including capital equipment, used for project implementation are eligible for import tax exemptions (both duties and other taxes). However, duty exemptions are only granted if the goods in question are not produced domestically. While provision is made for quality and price differentials, this is clearly a disincentive for exporters and can place them at a serious competitive disadvantage to exporters in other countries.

In principle, income tax concessions are determined according to the type and geographical location of the investment. New investments and rehabilitation of facilities paralyzed/destroyed by the war are entitled to a 50 percent reduction (80 percent in specific zones) of corporate and supplementary taxes, for a maximum of ten years, while other investment are entitled to a 100 percent deduction from taxable income, during five years. The elimination of outright tax holidays is a positive feature as it discourages the flow of transitory investments.

H. Remittance of funds

While the investment code makes provision for the remittance of funds (profits, royalties, debt service and invested capital) in the case of foreign investment, the terms for accessibility stated under the code are restrictive and constitute a source of great uncertainty. First, only foreign investment authorized by the CPI is entitled to transfer funds abroad, which means that this right is not automatic. Second, in addition to the certificate issued by the CPI, a investor must undergo registration procedures at the Ministry of Finance and Bank of Mozambique to be able to remit funds. Third, profit remittance are conditional on confirmation that outstanding tax payments have been met, that the legal reserve fund has been constituted/replenished, and that adequate provisions to cover debt service have been made on the loans contracted to finance the investment. While the first condition makes sense, the others are sound business practices which should not be up to the Government to enforce. There is also uncertainty as to whether profits could actually be remitted in any given year. According to the code, profit remittances shall be "promptly processed" as long as the positive foreign exchange balance generated by the investment allows for the necessary coverage. If no surplus were generated, the remittance will be processed the next financial year. Finally, implementation procedures are yet to be published by the Bank of Mozambique.

The impact on foreign investment from such restrictions is clearly negative and it is not surprising that many investors end up using alternative methods to remit profits illegally (e.g., through transfer pricing, technical assistance arrangements with headquarters). It is [7] strongly recommended that the right to remit funds abroad be made automatic for all registered foreign investment and not conditional to prior authorization by the CPI. Regulations regarding profit remittances should be greatly simplified and made more transparent. The requirements such as legal reserve funds and debt service coverage should be eliminated. Transparent implementation procedures on capital and profit remittances should be prepared and properly disseminated by the Bank of Mozambique as soon as possible.

I. Other Implementation Constraints

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7 For example, import-substituting firms can remit profits under terms to be agreed with the investor provided that it can be demonstrated that net foreign exchange savings have been generated.

Other key impediments reported by the private sector include the inefficiencies of customs and ports as well as the poorly functioning banking system. Main complaints among the business community are the lack of storage facilities and high security risk for trade cargo channeled through the various customs terminals (e.g., FRIGO, Maputo port), inefficiency and corruption of personnel involved in the clearance of goods including ADENA, the customs broker agent. In response, many companies are forced to set up parallel facilities (warehouses, specialized vehicles etc.) and deploy a considerable number of personnel to deal with customs. The lack of transparent and standard procedures to access duty exemption regimes for exporters is another major constraint for private sector development and exports.

In addition to imports tax payment, an importer typically incurs additional costs payable to shipping lines, port authorities and ADENA. Demurrage charges begin to accrue three days after cargo arrival (at US$15 to 20 per day per container). Because the dwelling time for a container in the Mozambican ports is exceptionally high, around 114 days in Maputo, shipping lines are charging a surcharge of US$225 for containers shipped to Maputo. Several reasons explain this situation including lack of funds to pay import taxes and other import charges by both Government and private importers, inadequate information systems to communicate arrival of cargo, and shortage of storage facilities. A more efficient system would include longer grace periods (e.g., fifteen days) and steeper demurrage charges thereafter. While the new legislation makes provision for the operation of private customs brokers, in practice ADENA still functions as the sole customs agency. Charges are high, equivalent to 1-2 percent of import value, and hidden payments are reportedly necessary to speed up the completion of required paper work.

Another major constraint to the private sector is the inefficiency of the banking system. By and large, poor performance results by the lack of competition and relative predominance of state-owned banks which suffer from management and capacity weakness. Common problems include long delays in undertaking any standard bank transaction, e.g., opening a letter of credit takes at least three weeks at the Commercial Bank of Mozambique (BCM). In addition, access to credit to the private sector has been restricted as most of the credit was being absorbed by loss making parastatals. It is expected that this situation can be improved in the medium term with the on-going reform of the financial sector (supported under the current IDA funded structural adjustment operation), which includes the restructuring and privatization of state-owned banks and the entry of new banks.

Privatization Policy and Implementation

I. Introduction

The slow pace of privatization of large industrial firms has delayed enterprise restructuring within the industrial sector with adverse repercussions on output performance and overall macro-economic stability, especially since privatization has been made the main instrument to address the restructuring needs of state-owned firms. While significant progress has been made in the last half of 1994 in the divestiture of state-owned companies, approximately two-thirds of gross industrial output remained under the control of state-owned firms by the end of 1993. By February 1995, however, 19 large enterprises had been sold with 10 more in the final stage of privatization, reducing state control of gross industrial output to roughly one-third of the total value of industrial output.

Loss-making operations of many firms have been covered partly through direct budgetary subsidies, amounting to one percent of GDP in 1993, but mostly thorough indirect transfers (through the banking system, subsidized inputs, and inter-enterprise debts). Not surprisingly, *large state industrial firms account for a high percentage of the non-performing loan portfolio of* the banking system. Inevitably, the transfer of resources to loss-making state enterprises has crowded out access by the private sector, further constraining output recovery in the industrial sector.

Apart from the adverse business environment confronting the industrial sector overall, most state firms are additionally burdened by problems of poor management, low productivity, and a heavy debt burden. In addition to management and financial restructuring, these firms are also in dire need of substantial physical rehabilitation to expand capacity utilization. In some instances the Government has initiated expensive rehabilitation projects prior to privatization, with the support of external donor financing.

Several reasons account for the slow pace of privatization of large firms, including the delays incurred in the preparation of an appropriate institutional and legal framework and the uncertainty generated by the war. Because of the lack of domestic savings, one key factor for the success of the privatization program in the post-war period clearly depends on the country's ability to attract foreign investment either through direct sales or joint ventures. Therefore, improving the investment climate, by simplifying the legal and regulatory to start up and operate a business, is a key priority. In addition, a number of other problems specifically associated with the privatization process itself need to be addressed in order to speed up and ensure a successful program. These include: (I) lengthy preparatory procedures; (ii) excess labor issues; and (iii) the need for additional transparency in the bidding and sales process.

II. Slow Preparatory Procedures

The situation facing some state enterprises has been worsened by the uncertainty caused by the slow pace of privatization. In an effort to demonstrate commitment to the privatizatión program, the Government announces early on in the process which companies are to be privatized. Once the announcement is made, it becomes difficult for the enterprises in question to do business. Credit dries up, as banks face uncertainty as to the status of loans following privatization. For the same reason, foreign customers are reluctant to enter into contractual arrangements with such firms. Since most of these companies are incurring operating losses, reduced access to bank credit affects their ability to meet variable costs such as workers' salaries, and operations are rendered virtually impossible. In some instances, this period of uncertainty has lasted up to almost three years (see Table 5.1).

Table 5.1 sample of Larger Firms to be Privatized and their Status as of the end-1994

Company name	Sector	Date first announced	Current status
Agro-alfa	Agricultural equip.	Apr. 1993	In bidding stage
Caju de Mozambique	Cashew processing	Nov. 1991	2 of 7 units sold in Dec.'94
Carbomoc	Coal production	Feb. 1994	DPR still being completed
Cometal	Metal working	Nov. 1991	Reopening bidding process
Comp. Ind. da Matola	Grain milling	Apr. 1993	1 of 2 units sold
Companhia do Boror	Copra production	Apr. 1993	DPR being reviewed
Encatex	Clothes distributor	Apr. 1993	In bidding stage
Emplama	Plastic molding	Nov. 1991	3 of 5 units sold
Fabrica de Cerveja - 2M	Beverages	Apr. 1993	Bidding completed
Fasol	Soap & oil prod.	Apr. 1993	Sold in Nov. '94
Forjadora	Metal working	Nov. 1991	Sold in April 1994
Geomoc	Construction	Feb. 1994	DPR yet to start
Mobeira	Grain milling	Feb. 1994	DPR yet to start
Soveste	Garment mfg.	Apr. 1993	DPR being reviewed
Steia	Equip. wholesaler	Apr. 1993	In bidding state

Source: Boletim da Republica, UTRE, Ministry of Finance. [8]

[8] For example, garment manufactures working under sub-contracting arrangements have been particularly hard hit by this problem (e.g., Soveste). Foreign customers, which ship cloth for assembly into the factories, have sought alternative manufacturing sources in order to avoid

UTRE, the privatization unit within the Ministry of Finance, which was created in 1991 to oversee the privatization of 'large' firms, has sold nineteen large companies, thirteen of them during 1994. This recent progress is commendable, but delays up to this point can explain the lack of restructuring that has occurred within the industrial and other sectors. For example, only enterprises sold during 1994 are expected to begin to have a significant impact on output as indicated in Figure 5.1 below. Another delay stems from the actual selection of which companies are to be privatized. Line ministries must first select which companies are to be privatized by UTRE. Numerous companies have never been identified for privatization due to vested interests within the ministries in retaining certain enterprises.

The procedures for the privatization of large state-owned firms can be lengthy and complicated. In some cases, the preparation of the Diagnostico do Potential de Reestruturação (DPR) requires excessive information, is time consuming and is expensive. While the DPR process is important to clarify ownership issues and to put the finances of the company to be sold in order, the DPR actually collects much information which is not essential to the sale of the company. UTRE is currently reviewing the DPR formats with the aim of shortening the time required for completion to two-three months.

Box 5.2: Pro Forma Requirements and Costs of the DPR

- The average DPR includes seventy-five separate tables describing various aspects of the enterprise being sold: from a ten year projection of cash flows based on a hypothetical investment to historical balance sheets of the firm, which in many cases needs to be put together for the first time.
- Nine separate annexes.
- Seven charts including a Gant Chart showing the future rehabilitation program for the enterprise and a graph depicting historical sales of the company.
- The DPR for Caju de Mozambique took nine months to complete, cost US$120,000 and is just under 500 pages long.
- The DPRs and sales memos for Boror and Emocha, the state-owned copra and tea companies, will cost US$290,000 and US$300,000 respectively and are expected to take over eight months to complete. Sales for Boror in 1993 were only $432,000.

Furthermore, the valuation method used to determine the 'reference price' of the company. also part of the DPR, could be simplified. The current estimation method involves the calculation of the net present value of the firm's projected cash flow assuming hypothetical, projected investment levels. Such valuations are very subjective, based on weak assumptions, and are not suitable for setting a realistic value for the firm.

Bearing in mind that the selling price of any company should be ultimately determined by the market, it is acknowledged that some sort of valuation can be used to help set a floor price. However, such reference price could be estimated using less complicated methods, e.g., based on

the risk of becoming caught in a legal limbo during the privatization process.

the current cash flow net of debt service or the scrap value of the assets. In fact, the technical methods employed in preparing a DPR valuation seldom determine the market price for an enterprise. Moreover, overvaluation and unrealistic price expectations published in the Sales Memorandum prepared from the DPR can delay the privatization process by scaring off potential investors. Interviews with both local and foreign potential investors indicate that inclusion of these reference values in past Sales Memoranda may have led these investors to believe that the Government expected prices in this range. This has kept some of these investors from pursuing the matter further, an undesirable result from the perspective of the Government.

While it is important that a reasonable price be ensured for the sale of a company, the main objective of privatization is, above all, to attain sustainable enterprise restructuring through the transfer of assets into more productive hands. These enterprises are of more value to the Government when they begin to generate a profit and pay taxes, and to the economy as a whole through job creation, foreign exchange generation, etc. Therefore as long as the process is delayed these enterprises will continue to be a drain on the economy, rather than a net contributor.

III. Redundant Labor

The employment policies of the last two decades have resulted in redundant labor in state enterprises. While some state companies have undertaken a reduction in their work-force by using severance pay, most have not. There are two main constraints to the reduction of the labor-force: (I) most state-owned enterprises are in financial difficulty and do not have the cash to pay the legally-mandated severance pay; and (ii) the Government is especially sensitive to laying-off workers. Labor unions have a strong and important role both at the firm and national level. After years of socialist policies, workers and unions have come to feel some sense of "ownership" in state enterprises, and workers feel they have a right to their job.

Faced with difficulties in reducing their work-force, combined with other operating constraints, state-owned enterprises with cash-flow problems have difficulties in paying their wage bills. Consequently, many companies are asking all or part of their work-force to stay at home. While base salaries must be paid, the cost of providing transport, food, and health benefits are thereby reduced. Even with much of their work force at home, for "paralyzed" or "inactive" firms, the wage bill continues to constitute a large fixed cost. Many companies are often not able to pay salaries at all. Instead, they are accumulating debt in the form of salaries-in-arrears. These firms are also often not honoring their pension obligations (and thereby also posing a threat to the viability of the national pension scheme). In the industrial sector, many companies have not paid salaries in over six months. In the agricultural sector, this non-payment of salaries has lasted over two or three years. Some state farms have given workers pieces of the farm to cultivate for themselves in lieu of salary. In several instances, the non-payment of salaries has led to labor unrest and strikes.

The existence of redundant labor, the accumulation of salaries-in-arrears, and the consequent labor unrest among state enterprises are now posing a problem to the privatization of these companies. Current policies and practices relating to the sales process of state-owned enterprises effectively transfer these labor liabilities from the Government to [9] the private buyer. Such practices are also an attempt to distance the Government from the political and economic cost of the eventual retrenchment of these workers. Although Government practices have not always been consistent, the one unifying theme has been a policy by the Government to maintain firm-level employment during privatization and to pass labor liabilities to the private buyer.

The current labor law, written in 1985 prior to reform, is outdated and irrelevant in a non-command economy. It provides no guidance, for example, regarding labor issues arising from privatization. In the absence of applicable law, a Tripartite Commission of government, union leaders, and management representatives meets regularly. They resolve outstanding labor issues and have initiated preliminary discussions regarding the revision of the labor law, although nothing definitive has been enacted yet.

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9 For example, a worker that has been employed with the firm for sixteen years, would be entitled to twenty-four months of salary as severance pay, presenting a prohibitive cash-flow problem to most state-owned enterprises. This is true despite the fact that average salaries in the industrial sector are on the order of only US$38 per month and the non-agricultural minimum wage is on the order of US$ 18 per month. This system also encourages companies to lay off their newest workers, rather than trying to develop an early retirement package for older workers.

Box 5.3: Labor Liabilities are Hindering Privatization

At the level of the National Commission for Valuation and Privatization (CNAA), prospective buyers of small and medium enterprises are being required to ensure that the firm they privatize will continue to engage in the same productive activity and will be purchased with the same work-force (in its entirety and with existing labor contracts). According to people who sit on this Commission, the labor retention requirement is obligatory. A high bid that proposes a lower work force will be rejected. In other words, the price is not being allowed to incorporate the cost of redundant labor (or the cost of removing redundant labor).

With full ownership of title, newly privatized companies may down-size their labor force by paying the legally-mandated severance pay. However, many private firms have transitional title of ownership for three to five years until they have paid for the company in full. During this time the Government has the leverage to ensure that the work force is retained as per the sales agreement. There have been several cases in which prospective private buyers of state-owned enterprises were also asked to incur the pension liabilities of the enterprises to be sold.

In the case of large and strategic firms being sold through the privatization unit within the Ministry of Finance (UTRE), there have been fewer sales and little precedent with respect to the labor retention requirement. In two cases of state-owned enterprises with redundant labor there was some discounting of the sales prices in exchange for the retention of the whole labor force. However, UTRE believes that the labor retention requirement may be the cause for a lack of interest among prospective buyers in bidding for HIDROMOC, for example, with its estimated 200 redundant workers.

The financial costs of retrenchment will not be trivial. These costs will include: (I) the severance pay for all workers of liquidated companies; (ii) the cost of voluntary retrenchment of non-liquidated state companies; (iii) the severance pay of still redundant workers in state enterprises in the process of privatization; and (iv) the cost of pension plans of state enterprises. For example, retrenchment of 30,000 workers assuming an average wage of twenty five US dollars and average worker tenure of ten years would cost US$ 11.3 million.

A re-deployment fund should be established to cover these costs of retrenchment. These costs should be primarily borne by the Government from revenue from the sale of state enterprises. Additional funding may also be required from donors. However, this fund does not yet exist in practice. According to the Ministry of Finance, up to very recently, revenues from the sales of small and medium scale enterprises, net of liabilities, have been too small to establish a functional fund. Consequently, these revenues go directly to the Treasury. With the recent sale of larger companies, such as Cimentos de Mozambique and some of the plants of Caju de Mozambique, the establishment of this fund should be a priority.

IV. Transparency in the Bidding and Sales Process

Experience worldwide with privatization has shown that to be successful, transactions should be transparent. It is also important that the perceptions of investors, whether justified or not, are that the program is administered fairly. Failing this, the type of investors attracted to the program may not be of the most desirable nature. Transparency can be ensured through clearly defined competitive bidding procedures, clear and simple selection criteria for evaluating bids, disclosure of purchase price and buyer, well-defined institutional responsibilities, and adequate monitoring and supervision of the program.

A number of potential investors seem to be under the impression that it is actually possible to influence the selection of a winner in the bidding process. Whether true or not, the perception that these irregularities exist in itself is damaging to the program. Some reasons for this include the subjective nature of awarding points in the final bidding for factors other than price (up to 80% of the final weight in many cases) and the fact that lengthy negotiations can take place with one or two selected bidders after the final bid has been closed.

To ensure transparency in the sales process, participating bidders should be invited to the opening of the bids and then information on the details of the winning bid should be publicized. In this way, all bidders can see how their bid fared compared to the others. UTRE has stated that it only intends to follow these procedures "in some cases". The CEP has also stated that it intends to "inv[illegible]ted bidders to the opening of bids in the sale of <u>some</u> companies". These procedures should be followed for <u>all</u> companies being sold, not just select cases. Similar procedures should be followed for the divestiture of the small and medium sized companies being sold by the privatization units within the various ministries (i.e., GREI, UREA).

Recently, UTRE has sold a number of companies on a delayed payment plan. As one of the main objectives of privatization is to transfer the possession of assets <u>irreversibly</u> from the government to the private sector, payment should be made on a cash basis. This is the only way that the umbilical cord between the government and a new firm will be cut. It will also ensure that the firm will not revert back to the government, nor use its unpaid balance to pressure the government into further concessions.