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MOZAMBIQUE CONSULTATIVE GROUP MEETING INTERAGENCY PAPER

APRIL, 1996

U.S. AGENCY FOR
INTERNATIONAL
DEVELOPMENT

April 5, 1996

MEMORANDUM

TO: See Distribution

FROM: USAID/AFR/SA, Wilbur G. Thomas

SUBJECT: Interagency Review for the Mozambique Consultative Group and Zambia Donors Meetings

You and your staff are cordially invited to participate in the Mozambique Interagency Review Meeting which has been scheduled as follows:

Wednesday, April 10, 1996
9:00 a.m. - 11:00 a.m.
Room 3676 - Main State Department

The hour following this meeting (11:00 a.m. - noon) has been reserved for a discussion of the Zambia donors meeting, which follows the CG in Paris. No paper has been prepared for the Zambia review.

Attachment: Mozambique Consultative Group Meeting - Interagency Review Paper

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INTERAGENCY REVIEW PAPER

NINTH CONSULTATIVE GROUP ON MOZAMBIQUE

I. OVERALL GOAL

The U.S. should use the opportunity to make clear that our goals are to ensure that Mozambique achieves both democracy and economic development. The international community invested a billion dollars to get Mozambique to and through the elections in 1994 and has invested billions to bring about its development. At present, Mozambique has neither the institutions required for democracy nor the foundations for development. Both these factors are due to government policies and priorities. Much more needs to be done by the GRM to assure that democracy is institutionalized and that development is realized. It should also be made clear that failure to achieve immediate and measurable reform will lead to reductions of our aid program.

The economic background section is essentially the same as in last year's paper but updated for 1995. For the readers who are familiar with Mozambique, they should skip to the recommended U.S. issues section.

II. ADMINISTRATIVE ARRANGEMENTS

The World Bank (IBRD), at the request of the Government of the Republic of Mozambique (GRM), has called the Ninth Consultative Group (CG) meeting for Mozambique on April 16-18, 1996, in Paris, France. Ms. Catherine Marshall, the World Bank's Director of Programs for Southern Africa, will chair the meeting. The U.S. Delegation will consist of: Ms. Carol Peasley (Head of Delegation), Deputy Assistant Administrator for Africa; Ambassador Dennis Jett; Mr. James Smith, Acting Director, USAID/Mozambique; and Margie Rauch, U.S. Treasury. The GRM delegation will be led by Mr. Pascoal Mocumbi, Prime Minister.

The IBRD is distributing the following two documents for the meeting:

IBRD, *Country Assistance Strategy for Mozambique*, November 1995; and GRM, *Steps Towards Economic and Social Development*, April 1996.

III. BACKGROUND INFORMATION

A. Political Situation

1. Background

From independence in 1975 until the mid-1980s, the GRM's domestic and external political orientation was toward the Soviet Bloc. Around 1984, the GRM began a shift to a more market-oriented economy and to more democratic governance. Externally, the GRM established relationships with the West and adopted a more non-aligned position on international matters. Internally, one manifestation of the GRM's political opening was the adoption of a new constitution in November 1990. Concomitant with the more significant progress in economic reform and the opening up of the political system in the early 1990s, the GRM and the Mozambique National Resistance (RENAMO) began serious peace negotiations which culminated in the signing of a General Peace Accord in Rome on October 4, 1992.

The signing of the General Peace Accord ended 16 years of civil war and began a transitional process from war to peace. From mid-1993 to mid-1994, Mozambique undertook one of the world's largest mass movements of people. About 1.7 million Mozambican refugees from six neighboring countries returned to their home areas, about 3.4 million of the estimated 4.5 million internally displaced also returned to their places of origin, and about 200,000 demobilized former combatants and their dependents returned home.

The transition process culminated in October 1994 in Mozambique's first ever multiparty national elections for the presidency and the Assembly of the Republic. The elections were based on universal adult suffrage. Thirteen candidates contended for the presidency and fifteen political parties for the Assembly. The FRELIMO candidate and incumbent, Joachim Chissano, won the presidential contest with 53% of the vote and the FRELIMO party managed a slim majority in the new Assembly with 43 percent of the popular vote. Voter turnout was high, the number of spoiled and blank ballots was relatively low (under 10%) and Mozambican pollwatchers and the international community deemed the process free and fair. Political tensions remain, however, as the FRELIMO party chose not to create a government of national unity and RENAMO has not been included in any government position at the national or provincial level. RENAMO, Mozambique's other major political party, won solid majorities in all five central provinces, including the two most heavily populated in the country, and earned 112 seats in the 250 seat parliament.

2. Current Political Situation

The October 1994 elections constituted a major step in introducing multiparty governance to Mozambique. Political power, however, continues to be concentrated in the executive branch, with weak and underfunded legislative and judicial branches and a largely state-owned media that are not effective counterweights to executive dominance. The main tasks ahead for Mozambique are the consolidation of multiparty governance and democratic institutions, which involves a shift in emphasis from an overly centralized executive branch to a more effective system of checks and balances amongst the three branches of government. The Assembly may not be a rubber stamp anymore, but it has no real power and the governing party wins all key votes of interest to the government. At the same time, government transparency and accountability needs to improve, processes that will be stimulated by a more effective partnership between government and the citizens it serves.

Complementary to the issue of decentralization is that of local elections. The GRM linked the holding of local elections to the decentralization process, generating controversy within the government as well as between the government and the opposition and within the opposition about the feasibility of holding simultaneous elections in all of Mozambique's 128 districts. The GRM cited the lack of consensus, as well as the debate over the constitutionality not only of the packet of laws but also of the Municipal Law of 3/94 itself, and withdrew the laws from the Assembly, with repercussions for whether the local elections would take place as scheduled in October 1996. An Ad Hoc Commission on elections was formed in the Assembly to assess the situation, but it has not yet made public its conclusions or recommendations. Local elections remain the key next step in consolidating the democratic transition.

B. Economic Situation

1. Background

1. Pre-independence

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. 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 1930's 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, footwear, 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% per annum. The metals and engineering industry subsectors recorded annual growth rates above 30%. 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.

2. *Post-independence*

After a long period of armed warfare in the fight for independence from Portugal, Mozambique became independent in 1975. A substantial exodus of Portuguese settlers at the time of independence in 1975 severely depleted the pool of skilled labor (approximately 90% of the skilled 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 impact of the exodus was further exacerbated by the sabotage by departing Portuguese of productive resources. Due to damage and losses from attacks on the railways by RENAMO, transit trade from the Transvaal in South Africa, which had been an important source of income for the port of Maputo, was diverted during this period to other South African ports rather than through Mozambique. 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 emerging civil war which devastated much of Mozambique's countryside and infrastructure.

The 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 service the raw materials requirements of Portugal and the manpower needs of neighboring countries (which, of

course, meant that it was neither physically nor economically integrated). Few Mozambicans were employed in the modern sector, especially in managerial positions.

Immediately post-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. In agriculture, 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 and 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 warfare in the region and growing internal conflict.

As a result of civil war in neighboring Zimbabwe, and due to unpopular Marxist policies internally, the Mozambican National Resistance (RENAMO), initially created and financed by external sources, was able to mount an increasingly effective war of sabotage and destruction in Mozambique in rural areas from the late 1970's until 1992.

3. *Economic Collapse: 1981-1986*

In the early 1980's 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 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 population in urban centers but also 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.[1] 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 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.

4. *Economic Adjustment: 1987-1996*

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 paralyzed (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 1980's 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).

In 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 over 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 was 5.0% in 1994 but declined to 3.0% in 1995.

Trade reform was 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). 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 only increased to $148 million, while imports were $1 billion (75 percent of which was financed by donor import support funds). Imports fell by about $235 million in 1995 (of which $190 million can be attributed to the discontinuation of special programs). Exports increased to $170 million. Mozambique will continue to need substantial foreign aid over the short to medium-term, as well as additional debt relief on highly concessional terms from Paris Club and other official bilateral creditors.

Despite significant debt relief, Mozambique still has an external debt of over $5 billion,

mostly owed to bilateral creditors. Debt rescheduling on concessional terms helped lower Mozambique's debt service ratio to 25% of exports of goods and services in 1995 but this still represents a heavy burden on the country's budgetary and external resources. The current debt situation is discussed in more detail in General Issue #3 below.

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 5% by the end of 1995. 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.

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 revised urban residential and commercial rents in 1995 which have been basically frozen since 1991. However, these still constitute significant subsidies relative to the commercial market, e.g., the rental price of a government-owned 'flat' was raised from MT 4,000 to MT 8,000 per month (less than $0.10). Senior GRM officials typically rent houses for about MT 75,000 per month (less than $7.00) while their expatriate neighbors rent similar houses for $2000-3000 per month.

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 17.8% in 1995. Some progress was made in prioritizing public expenditures. The budget slowly became more transparent and 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 situation improved markedly in 1995 with the fiscal deficit, before grants, reaching 18% of GDP and, after grants, 4.3% of GDP.

Enterprise reform succeeded in privatizing over 400 small and medium-enterprises from 1987 to date. Since 1992, forty-five new private enterprises have been established as a result of the privatization of previously large state-owned enterprises. Enterprises privatized in 1995 included cement, construction materials, steel, plastic, soap and oils, fishing, breweries, clothing, cashew processing and retail businesses. However, reform of key 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 mid-1994, approximately two-thirds of gross industrial output remained under the control of state-owned enterprises. 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 1995 regarding privatization of large enterprises.

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 Mocambique (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 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%). 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%). Inflation reached 54.5% by the end of December (significantly above the original target of 24%).

Despite the initial gains of the ESRP, deep structural problems continue to hamper Mozambique's economy, contributing to inflationary pressures and impeding a supply response in the economy. With a per capita income of about US $90, 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.

5. *Statistical Note*

The quality of statistics in Mozambique is truly appalling. GDP is compiled only in terms of uses of resources (consumption, investment and net exports). Intermediate consumption data is not available which precludes any estimates of value-added. Private consumption is compiled on the basis of the estimated private sector wage bill and autoconsumption. Gross investment excludes changes in stocks because of the lack of reliable data. Data for savings and investment are essentially residuals calculated from other numbers that are problematical. Gross output merely measures the gross value of transactions as opposed to value-added. There are significant problems with all of the economic accounts in Mozambique. Although efforts have been underway to improve data collection, unless significant improvements are made in the near future, the efficient economic management of Mozambique's economy will be very difficult, if not impossible.

IV. World Bank and Host Government Expectations for the CG

The GRM's principal theme for the CG meeting will be to mobilize pledges from donors to support the economy. The World Bank's and GRM's expectations for the CG are to generate sufficient donor pledges to support the adjustment program, and continued economic growth as well as the democratization process. The financing to be requested in support of the adjustment program totals approximately $1.5 billion.

While the specific discussion of the GRM's economic policies will depend on the points raised by various donors, the Bank expects that several areas will receive special attention. First is the issue of privatization of the state-owned banks. Second is the privatization of customs management. The third area will be fiscal policy, particularly regarding the expected budget reduction as the level of counterpart funds falls as donor resources decline (due to overall reductions in donor foreign aid budgets and increasing requirements for other regions). In particular, the Bank is concerned about the effect of this decline in donor support on the investment and recurrent budgets, the lack of transparency and accountability in the budgetary process and the urgent need for tax and customs reform. Finally, key general issues will be discussed relating to development of a growth with stabilization strategy, debt relief and corruption.

V. RECOMMENDED U.S. POSITIONS FOR THE MEETING

A. General U.S. Position

At last year's CG, the GRM made a number of promises, most of which have yet to be implemented. This year should be the "CG of Accountability," particularly regarding privatization of the state-owned banks and the privatization of customs management. Achievement of these key structural changes is a critical first step for the transformation of the Mozambican economy, a transformation which is increasingly urgent because external assistance is certain to decline over the coming decade. We will call upon Mozambique to set as its objective the elimination of dependence on external assistance within ten years and its replacement by domestic resource mobilization, export earnings, and foreign direct investment.

In November 1995, a group of major bilateral and multilateral donors, including the U.S., issued a Donor Statement addressed to the IMF and the GRM. In this statement, donors expressed their concern about the possibility of a disruptive on/off donor flow of funds cycle related to the GRM being off track under the ESAF. The donors agreed to support the structural adjustment and economic policy reforms of the GRM with balance of payments support if and only *if* the GRM focused on the implementation of changes in a few crucial areas which constitute the sine qua non for economic growth with stabilization in Mozambique. These five areas are:

- Tax and Customs Reform;
- Financial Sector Reform;
- Private Sector Development;
- Combating Corruption; and
- Democratization.

All of these five problem areas were identified as key components of the policy reform process at the last CG. The Donor Statement while appealing to the IMF to be somewhat flexible in their demand management approach so as not to slow economic growth, was primarily a strong request to the GRM to get on with its promised and much-needed structural reforms, to increase transparency and accountability, and use scarce resources more efficiently and productively. Unfortunately, the GRM and its supporters in the local and international press distorted this message and interpreted it as the donors pushing the IMF for greater understanding while ignoring the need for more rapid economic reform, In part as a result, implementation of these measures has been far too slow to establish the conditions for sustained growth.

To counteract this foot dragging a wider group of donors, led by the U.S., drafted a "Speaking Notes" paper to the GRM which suggested that the Government, in view of scarce human and financial resources, should focus on the implementation of priority policy reforms. After word-smithing, all the donors agreed on the recommendation of specific policy actions with timetables in the above five policy areas and these were presented to the GRM in January. These policy actions constitute the primary areas of concern to the U.S. and other donors in Mozambique, encompass the promises made by the GRM at the last CG, and are consistent with agreements between the GRM and the Bretton Woods institutions. Implementation of them, however, continues to be incomplete calling into question the GRM's commitment and ability to implement its own program.

As discussed below in greater detail, the GRM faces a number of difficult challenges in its attempt to accelerate economic and social development. The outcomes for two critical macroeconomic variables over the past several years are warning signs of insufficient economic stability and unproductive resource use. As the IMF has reported, inflation and money creation are far too rapid and, if not brought under control, will choke off economic growth. On the other hand, there is an urgent need on the part of Mozambique to use scarce resources more productively and more transparently and to create an environment for rapid economic growth. The GRM must achieve greater discipline in this aspect of macroeconomic management. Privatization of the state-owned banks and improved bank supervision are essential if IMF benchmarks with respect to monetary targets are to be met.

If the GRM implements its structural reforms and develops a firm foundation for rapid economic growth, the U.S. could consider maintaining its economic assistance program for FY 1997. On the other hand, we must make it clear that if the GRM fails to implement its reform program, the U.S. will consider reducing its investment in Mozambique's economic development and concentrating its efforts elsewhere.

At this point in time in Mozambique's history, Mozambique has a unique opportunity to redefine the role of the state and bring about greater social and economic development. From the point of view of structural adjustment, two variables will affect the definition of that new society. One, Mozambique will, as will most other countries receiving donor assistance, operate in a context of declining foreign assistance. Budget support through donor assistance to balance of payments will decline this year (an estimated 28% reduction). Two, the role of investment, both domestic and foreign, will be increasingly important. The currently stagnant levels of private sector investment (excluding ENRON) need to be increased. To do this, Mozambique needs to address the direct and indirect interventions by the state in the economy, the lack of confidence in the private sector, the delays in key privatizations and severe constraints in the business environment, including taxation, tariffs, licensing and registration requirements, and customs.

Maintenance of assistance levels will be strongly influenced by transparency and accountability for public funds, progress in implementation of policy reforms, and the results of programs and projects on the ground. Now that the war is ended and a state of emergency no longer exists, the GRM needs to effectively and productively use its scarce resources, including those from donors, to alleviate the extensive poverty that exists in Mozambique. A significant acceleration in the pace of reform is needed. A clear presentation of a strategy for economic growth and development, particularly in the agriculture sector, based on a realistic assessment of available resources and Mozambican human resource capacity will enable the donor community to improve the effectiveness of its resource transfers and mobilize in such a way as to be more responsive to domestic concerns. Such a strategy will need to include a redefinition of the government's role and an indication of consultation with the private sector, nongovernmental organizations, local communities, and donors.

General Issue 1: Development of a Growth Strategy with Structural Adjustment

Discussion: Development of a growth strategy **with** structural adjustment is crucial to Mozambique's short-term and long-term development. The prospect for rapid economic growth is especially strong since the outputs of key sectors, e.g., cashews and port services, are far below peak levels achieved prior to independence. Mozambique's economic growth potential is also favored by its proximity to South Africa, given Mozambique's ports, agricultural endowments and its scope for rapid reconstruction in key infrastructure (transport, telecommunications and energy). Success in creating the right environment will encourage investment and begin to resolve the supply rigidity problems that contribute to inflation, thus setting the stage for rapid economic growth.

Recommended U.S. Position: That the GRM in conjunction with multilateral and bilateral donors develop a framework for broad-based, sustainable economic growth. The following priorities should be addressed:

- completely liberalize the trading system (freedom to export and import without licensing, quotas or restrictive tariffs);
- immediately establish a flat, uniform tariff rate;
- promote exports (especially agricultural products);
- remove the current cascading tax system and implement a simple tax system to promote incentives and avoid corruption and administrative complexity;
- completely deregulate agricultural marketing and distribution;
- completely eliminate taxation on small-scale agriculture and small and medium-enterprises;
- develop and implement a public infrastructure program that emphasizes reconstruction and agricultural export development; and

- completely deregulate and privatize at least the management of the infrastructure sector, especially to encourage foreign investment in ports, transport (including coastal shipping), telecommunications and energy.

General Issue 2: Corruption

Discussion: Corruption has increasingly become a major concern for the donor community and Mozambican civil society. The disappearance of over 1,800 tons of USAID-provided yellow maize last year is merely one of numerous examples of corruption. As a result of this, the GRM lost $4 million which would have generated much-needed counterpart funds for the budget. ASDI has become so weary of dealing with corruption in the Ministry of Agriculture that they will no longer program their funds through the Ministry. The impact of corruption is manifesting itself throughout Mozambican society and is clearly derailing prospects of economic recovery as scarce resources are siphoned off and used unproductively. Donors have to send a very clear message at this CG that the level of corruption in Mozambique threatens the country's ability to attract investors and stimulate sustainable economic growth. The GRM runs the risk of losing significant donor support if corrupt practices are not curtailed. This corruption involves the highest levels of government and is a serious obstacle to reform in the agricultural, transportation, and mining sectors. Another area of growing concern is the increase in drug trafficking. Credible allegations of senior governmental involvement are rife.

Recommended U.S. Position: That the GRM take concrete steps to address the problem of corruption. The following priorities should be addressed:

- Resolve the issues identified with the stolen maize donated by USAID or face the elimination of our Title III program;
- Establish an independent Higher Authority immediately after the CG to investigate and monitor corruption;
- Establish transparent procedures and clear lines of responsibility for the entities that treat the legal as well as administrative aspects of alleged corruption cases;
- Provide records of assets and liabilities owned by senior Government officials and their immediate families;
- Provide transparent and regular information to the public on measures taken to prevent and/or deal with corruption; and
- Eliminate ad hoc decision processes involving tax and customs enforcement and registration and licensing procedures, particularly for foreign investors.

General Issue 3: Debt Relief

Discussion: Mozambique's external debt is $5.3 billion (including $900 million of non-military debt and $1.5 billion of military debt to the former Soviet Union, which is still

under negotiation). This represents almost four times GDP. Roughly $1.3 billion is owed to multilateral creditors and slightly less than $4 billion to bilateral creditors (Mozambican debt to the U.S. is only about $53 million - EXIM Bank credit number R-194). The major bilateral creditors are Italy, France, Germany and Portugal. Italy, however, canceled $190 million (roughly a third of their total debt) in February 1996. Roughly 90% of the overall debt is medium and long-term debt. Debt service payments of roughly $40 million as a percent of the total current budget will equal 17% (second only to defense and security expenditures). The high debt service burden remains excessive and is the source of many pressures towards increased taxation, excessive austerity, and depletion of foreign exchange reserves.

Mozambique needs fundamental debt relief. After all of the emergency reschedulings, the debt service ratio (relative to exports of goods and services) is forecasted to rise from 25% in 1995 to around 40% in 1998. This rise is inconsistent with rapid growth targets. However, it is clear that Mozambique has wasted resources and ignored principles of sound economic management. Many investments have been wasteful and there has been too much consumption. Resources were not channeled into productive investments that would eventually pay off Mozambique's debts.

The country's stabilization and structural adjustment programs under the auspices of the IMF and World Bank, respectively, have provided substantial credits in return for Mozambique's adherence to a program of macroeconomic adjustments and microeconomic reforms. This should have contributed to debt reduction by reducing the GRM budget deficit and the balance of payments deficit. In addition, this should have contributed to containing inflation, stimulating savings and generating more resources for investment and debt service. It did not, which means that resources were used inefficiently and unproductively.

Recommended U.S. Position: That the U.S. support the provision of debt relief by multilateral and bilateral creditors **only** if substantial conditionality is attached. At the same time we should urge donors to close any assistance that is not a grant and encourage the World Bank to move away from a bureaucratic culture that equates their performance with the amount of new loans made. For its part, the GRM should pledge to refrain from undertaking any new debt obligations unless they are economically justifiable and cannot be undertaken by the private sector.

B. Specific Issues[2]

The U.S. delegation should indicate our support for the adjustment program and especially for the GRM's economic team. However, while expressing appreciation of the dilemma faced by the GRM in addressing the myriad of critical short and medium-term problems, the Delegation should urge the GRM not to allow the multitude of issues and requirements to divert their attention from the continued necessity to implement key areas of the adjustment

program. The U.S. delegation should stress the importance of the GRM continuing reforms in the following areas. We recognize that many of these reforms will take considerable time to formulate and implement fully. Some, however, can be accomplished more swiftly, i.e., immediately or within the next few months. The GRM should set as its twin goals meeting IMF fiscal and monetary targets and immediately beginning the implementation of other needed reforms that will lay the groundwork to develop a much-needed supply response in the economy.

The areas for critical attention are:

inflation and financial sector reform;
tax and customs reform;
improve the business and investment climate;
budget reform; and
land tenure.

Issue 1. Inflation/Financial Sector Reform

Discussion: Inflation continues to be the major source of macroeconomic instability. Monetary policy has aimed at eliminating bank financing of the budget and controlling the expansion of money supply in order to reduce inflation. Net domestic bank financing of the budget, which amounted to 16.5% in 1986, has been eliminated and net repayments have been made since 1994. However, monetary control has been difficult after the separation of the Commercial Bank of Mozambique (BCM) from the Bank of Mozambique, the central bank, in 1992.

Inflation for 1995 averaged 54.8%. Inflation over the 1990-1995 period has averaged 46.4%. Inflation remains a primary concern and the reform of the central 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. As in previous years (despite 'tight' monetary and fiscal policies), money and credit expansion led to a significantly higher than programmed target for inflation in 1995. By the end of December, the accumulated rate of inflation was 54.9%, significantly above the revised program target of 35% (the original target was 24%). The rapid expansion of monetary aggregates adversely affected price performance in early 1995 as it did in previous years. Monetary growth at 52% was led by credit expansion to the economy through the two state-owned banks which overshot their credit ceilings. The primary problems underlying inflation are monetary expansion, particularly credit expansion through the two state-owned banks to public enterprises, and structural impediments.

The basic conclusion of the U.S. and the rest of the donor community is that inflation will not begin to be controlled until the two state-owned banks, the Commercial Bank of Mozambique (BCM) and the People's Development Bank (BPD), are privatized. The two state-owned banks dominate commercial banking activity in Mozambique. Massive leakages have occurred and are continuing to occur through these two banks. The central bank appears to have no control whatsoever, in terms of supervision and enforcement of prudential regulations, over these banks.

The sources of inflation in Mozambique, which include implicit subsidies to inefficient public enterprises, tariff and tax evasion, financial sector leakages and bad credit policy on the part of the state-owned banks, and policy-induced supply rigidities, are among the major obstacles to the achievement of high, sustainable levels of economic growth. As the IMF has noted, a significant source of supply bottlenecks continues to be loose money which reinforces the necessity of a growth with stabilization strategy.

The GRM budget has not been able to generate the fiscal surplus necessary for repaying the banking system and for providing the basis for expansion of credit to the private sector. This has required the central bank to maintain a tight monetary stance with real credit to the economy declining. However, this in turn has generated disintermediation, with the net result of accelerating inflation and exchange rate depreciation but low economic growth. Reform of the fiscal system is a key component of the macroeconomic reform agenda in order to reduce excessive money growth and ensure the availability of credit for the ***productive*** sectors of the economy.

Recommended U.S. Position: The GRM should implement the proposed timetables, without further delay, for privatizing the two state-owned banks. In particular, the following should be observed:

- Put private banking specialists in BCM and BPD immediately to monitor credit and cash flow operations up to the point of sale;
- Privatize BCM by June 1, 1996;
- Privatize BPD by December 31, 1996; and
- If the target dates are not met, the Government should immediately begin liquidation proceedings.

Issue 2: Tax and Customs Reform

Discussion: The GRM is facing severe budgetary pressures as it seeks to redress the devastation caused by the war, periodic natural disasters and inappropriate economic policies (by its own admission fully half of customs and tax revenue is not collected due to corruption and inefficiency). The deficit, after grants, has been overwhelmingly financed by foreign borrowing. Donors finance 70% of the investment budget, 75% of imports and over 40% of

the current budget. Gross official development assistance is well in excess of 100% of GDP.

Massive evasion of taxes and customs duties takes place in Mozambique principally due to official and business corruption and the lack of human and financial resources for proper administration. This situation is exacerbated by ad hoc decision-making processes, including total exemptions, that facilitate rent-seeking activity. Government entities and individuals own, directly and indirectly, shares in a huge number of enterprises. However, many of these are 'exempted' from paying taxes. There are even large, formal private sector firms that do not pay any taxes despite making large profits.

The GRM needs to simplify its tax and tariff structures. Because the current system is complex there is more room for kickbacks, making it virtually impossible to eliminate or even reduce corruption. A flat tariff rate, e.g., would immediately eliminate many opportunities for corruption through the misclassification of imports. The internal tax structure should be extremely simple. The corporate income tax should be set at a low, flat rate above a fairly high minimum level. Small and medium enterprises and agricultural producers should be exempt from all taxation. This would only result in a reduction of 1-2% of the total revenues if the current system were maintained. Excise taxes (e.g., fuel taxes, luxury goods, etc.) could make up most of the balance of the tax revenue.

The situation at Customs is particularly egregious. The weak and corrupt Customs Department negatively affects foreign exchange earnings, industrial incentives (through highly negative effective rates of protection), foreign investment and the Government's ability to fight illicit drug trafficking. An analysis by the World Bank indicates that between 1990-1994, clandestine exports were $850 million which is larger than officially recorded exports ($814 million) over the same period. Interestingly enough, the chief area seems to the important fish and shellfish subsector which is increasingly being alleged to be linked to the drug trafficking trade.

Attempts to collect high revenues as a percent of GDP stifle incentives, create opportunities for corruption, and generally frustrate macroeconomic targets. The target for revenues as a percentage of GDP is 23% in 1996. This seems extremely high.. However, given the fact that the national income accounts data are virtually meaningless and GDP is probably greater than double the official level, this is not as high as it initially seems. Furthermore, the existing tax base is primarily composed of a decreasing number of formal sector firms while the vast majority of economic entities operate in the informal sector.

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. 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 for 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, payroll) and indirect (consumption, turnover, import duties, etc.) taxes, 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.

The corporate tax in Mozambique has been reduced from 50% to 35-45%, 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%, the total import tax on consumer goods amounts to a minimum of 65% when other taxes are included.[3] In addition, any move through the distribution chain would add a further 10% to the sale price. For an economy with a very low purchasing power and which is 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% to 439%. While the 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. In addition, on account of the payment of duties and import charges, the cost of imported inputs has been estimated at 16% to 33% above world market prices for many exports. As a result, the manufacturing cost for these products is estimated at 10-22% over world prices.

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, 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% 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 for many tax exemptions/deductions provided under the tax law. 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 MOF already indicates eligibility. In addition, the high level of exemptions and deductions is heavily tilted toward civil service employees and the FRELIMO political party and related organizations.

Recommended U.S. Position: The delegation should insist that the GRM adopt and implement the following reforms to promote sector activity and broaden its revenue base:

- Elimination of all nuisance taxes, e.g., the stamp tax;
- Put a private contractor in place to manage the Customs Department by May 30, 1996;
- Immediately establish a unified tariff structure based on a flat tariff rate between 10-15%;
- Simplify the internal tax system and eliminate the current cascading structure;
- Exempt small-scale agriculture as well as small and medium-enterprises from all taxation;
- Eliminate the individual income tax; and
- Establish a flat corporate income tax rate

Issue 3: Budget Reform

Discussion: The lack of transparency in the budgetary process remains a major concern for all donors. The GRM has not closed its budget books since 1984 and has not published an executed budget since 1991. Although the GRM and major donors established a budget working group in 1994, progress has been relatively slow. Shifts in budgetary priorities are inadequate, in particular the importance of defense and military current expenditures compared to health and education expenditures. The announcement in late February 1995 of a cut in defense expenditures and an increase in education and health expenditures was a step in the right direction. However, donors to date have not seen if these intersectoral reallocations were actually enacted. Moreover, defense and security expenditures at 3.6% of GDP for 1996 are still too high and are far beyond the level of what Mozambique requires and can afford.

The recurrent budget only covers a proportion (perhaps 2/3) of total recurrent expenditures. The rest is included in the capital (or aid) budget. The coverage of the capital budget is far from complete (in 1994, e.g., 59% of expenditures were carried out under the capital budget). It is impossible at this point in time to say how much is being spent for what. Investment projects tend to be undertaken primarily because there is political support and external financing available. It is imperative to unify the recurrent and capital budgets.

As in past years, counterpart fund generation was less than planned. The IMF noted in September 1995 that: 1) counterpart fund generations were used for purposes other than those originally planned in the budget: 2) counterpart funds were provided to companies who were supposed to repay their loans but did not; and 3) there are significant leakages in the system.

The GRM's policy has been to minimize subsidies by only providing budgetary transfers to those enterprises that were adversely affected by the war. However, significant implicit subsidies to enterprises has continued. Such implicit subsidies are acting as a significant drain on budgetary resources and creating problems in monetary policy. 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 or the central bank. This will obviously place further pressure on an already overstrained budget as the level of donor funding declines.

Recommended U.S. Position:

- Continue to decrease the level of defense expenditures;
- Continue to increase the level of health and education expenditures, including a major shift from tertiary levels to primary levels;
- Adopt the new Budget Law and classification system by the end of this year;
- Expand the role and function of the Budget Working Group to consider macroeconomic issues which affect the budgetary process and fiscal policy; and
- Fully cooperate with the ongoing Fiscal Management Review.

Issue 4: Business and Investment Climate

Discussion: As part of the dialogue on the future role of the government, the role of the private sector also needs to be defined. Privatization of the remaining state enterprises, particularly large enterprises, needs to accelerate to help mobilize private investment, promote greater efficiency in production, and enable the industrial sector to make the needed adjustments to the new international and regional economic context. Mozambique held its first private sector conference in 1995. At this conference, which included a large number of private sector firms and individuals, a number of recommendations were made which the GRM promised to fulfill. In addition, several measures were recommended in the World Bank Industrial Sector Recovery document presented at last year's CG. Progress has been glacial to date. The GRM revised its investment code last September but has not implemented the revisions.

This is reflected in the low level of productive investment in Mozambique. Foreign direct investment, in particular, remains at extremely low levels (around $35 million). The ENRON negotiations, which were successfully concluded last year, will provide an important

boost to the Mozambican economy, generating around $200 million of revenues per annum for the GRM if a gas sale is concluded on the South African side. However, even this important milestone was achieved only after intense efforts to overcome bureaucratic inertia and corruption. Mozambique can ill afford to continue such practices. There are simply no domestic savings to finance investment. The economy of this country will depend on foreign investment. If the business and investment environment is not greatly improved, simplified and made more 'investor-friendly,' then the people of Mozambique will be the ones who suffer.

Perhaps the best economic opportunity at present for Mozambique is the proposed Gauteng-Maputo Corridor project which was officially announced on February 19, 1996. It would create a 'development corridor' linking South Africa's Gauteng and Mpumalanga provinces with the port of Maputo. The implementation of this project would bring enormous benefits to Mozambique.

The corridor would entail developing a number of projects:

Ports. Maputo could once again be one of the chief outlets for South African exports, given that the main South African ports of Durban and Cape Town are at near capacity. Investment will be needed to improve port facilities even though many of the wharves have been privatized, and work is needed to allow larger ships entry into the port.

Roads. There are plans to build a joint venture toll road from Witbank -- one of South Africa's fastest growing industrial regions -- through Nelspruit to Maputo, with a single customs and passport control stop at the border.

Railways. Negotiations are taking place between the South African state railways, Spoornet, and CFM of Mozambique to modernize the tracks between the border and Maputo port. Additional sidings will also be constructed. The scheme is likely to cost around 5 million dollars.

The problem is that the South African, as well as Mozambican, officials see this as a government-directed effort at high priority projects of their choosing rather than providing incentives and conditions to encourage the private sector to decide where to invest. Reflecting this attitude the GRM recently appealed to donors for $300,000 to run a day and a

half seminar on the project to invited companies in early May. Unfortunately, some donors rushed forward with funds to support this idea and the resulting conference may do more to discourage investors rather than energize them.

Recommended U.S. Position: That the GRM, together with the private sector, eliminate critical policy and regulatory constraints to increased investment and speed up the implementation of privatization and deregulation, including increasing the transparency of the process.

- Effectively encourage private sector participation in the Gauteng-Maputo Development Corridor;
- Implement the recommendations made at the 1995 Private Sector Conference;
- Privatize the transport (including ports and coastal shipping), telecommunications and energy sectors;
- Completely deregulate agricultural marketing and distribution;
- Completely liberalize the trading system - freedom to import and export without licensing, quotas and restrictive tariffs;
- Complete the privatization schedule agreed to with the World Bank; and
- Put CFM on a sound commercial basis by either privatizing at least the management of all primary ports and railways this year;
- Liberalize air transport services before the end of 1996;
- Privatize LAM before the end of the second quarter of 1996;
- Authorize private entities to import petroleum products directly; and
- Achieve majority ownership and management by private entities of existing public distribution network of petroleum products by the end of 1996.

Issue 5: Land Tenure

Discussion: Security of land tenure, including buildings and land in urban centers, is essential to encourage private sector investment, domestic and foreign. An agriculturally based growth strategy is highly dependent on secure tenure by all participants--smallholders, small and medium farmers, large agricultural enterprises, and agribusinesses. Since the last CG, the GRM has made some progress in recognizing the importance of land tenure issues and their critical relationship to other socio-economic forces, e.g., improvements in agricultural productivity. Unfortunately, statist tendencies are thwarting serious land reform.

It is not clear that the GRM recognizes that smallholders play an important role in the economy. The GRM continues to grant land concessions on a huge scale in a non-competitive and non-transparent manner. These concessions, covering an estimated 15-20 million hectares have resulted in post-war displacement, overlapping and competing claims, land conflicts, unproductive speculation, discouragement of investment, and environmental degradation.

Although the GRM adopted a Land Policy in 1995, the follow up draft land law was intended to be widely disseminated and discussed throughout the country. In fact, in a significant departure from the proposed program, the draft law was changed significantly by the GRM in a non-transparent manner and circulated on a very restrictive basis bringing into doubt the transparency of the process and the involvement of civil society. Specific changes made to the law include:

the first draft separated licensing from possession (tenure) rights. The revised draft reverted to the current law where use and possession are connected thus providing a mechanism for the state to take possession of land, undermining security and investment;

the power of customary authorities was either weakened or removed. Customary authorities, customary tenure rules and conflict resolution procedures will continue to be unrecognized and operate outside the national tenure system which will have grave repercussions for tenure security and agricultural productivity for smallholder farmers and other commercial interests;

Both documents maintain restrictive 50 year time limits on leases, e.g., restrictions on land transfer and commercial use of land. These leases may be renewed but must be done under the name of a national enterprise. Consequently, while a foreign interest may hold the initial lease, subsequent leases must be transferred to a national enterprise. If the foreign interest wishes to maintain an interest it will be forced to form a joint effort with a national company. This directly influences the investment process and is a disincentive to productive, long-term investment as well as encouraging improper or destructive resource use. This inhibits the development of an open land market, invites the development of an informal market with high transactions costs and little security, and encourages corruption. It also reduces options for credit as foreign-held banks will be unable to foreclose on investments made because they will not be able to sell the assets; and

Perhaps most critical of all, in neither draft has the GRM considered provisions to change the way in which concessions are granted. This continues to be the glaring problem undermining investment and sound resource use. Neither draft attempts to develop procedures to disentangle those claims which are overlapping and competing.

To summarize, the proposed land law makes very little progress and replicates many provisions and intentions in the current land law. Rights are restrictive, limiting the potential for the development of a market in land rights, and it excludes the wider participation of civil society reflecting the desire of the ruling elite to essentially maintain the status quo. Provisions in this draft, and the way they were amended, are inconsistent with Mozambique's goals to achieve a more open and transparent political structure and liberalized economy.

Recommended U.S. Position: It is imperative that the GRM immediately implement a comprehensive land tenure program that includes free transfers, an adequate monitoring process, in order to ensure that all parties, especially smallholders, have an equitable and participatory stake in the allocation of productive agricultural land.

- The GRM should continue open discussion of the draft land law and conduct open discussions in a more transparent process;
- Separate licensing from possession rights;
  Recognize the power of customary authorities and rules as well as require customary community participation in demarcation and dispute resolution;
- Remove the requirement that land rights can only be transferred to a national company; and
- Establish clear, transparent procedures for conflict resolution regarding land tenure issues.

Issue 6: Lack of Vision

Discussion: The GRM's program consists mainly of telling the donors what they want to hear while dragging their feet on implementation. Either because of lack of capacity, inertia or a desire to preserve the status quo, the plan the GRM will present in Paris is a laundry list of good intentions, most of which were heard last year. Instead of this meeting being the CG of accountability, it is well on its way to becoming the CG of more of the same.

The Government also makes clear it has no longer-term plan for the country's development or any sense of urgency about implementing the plan they have. To break the dependency mentality, we should encourage development of a longer-term strategy with an end to assistance being the ultimate goal.

To make matters worse, unless priorities are set to achieve this goal, the GRM will find it difficult to resist pressures in other directions. While defense expenditures have been coming down, inevitably there will be a resurgent demand to squander resources on the military. For instance, plans are being considered for returning to universal conscription despite the total lack of any threat to justify increasing the military or any administrative capacity to run such a system. Instead, it would become another opportunity for corruption and waste. With 200,000 men reaching the proposed draft age of 17 each year and only 2,000 needed at most for an army of the present size (11,000), it is argued that the rest would be employed in some form of national service. No mention is made of women either in the military or the national service scheme. It is also argued that an all volunteer force would be too expensive, but no figure has yet been put on what it would cost to train, transport, clothe, feed and pay tens of thousands that would be doing alternative national service.

Recommended U.S. Position: Specifically, we should take note of the UN initiative on Africa and urge:

- The Government to adopt as its highest national priority the goal of providing universal primary education within 10 years;
- The other donors to consider the elimination of development assistance to Mozambique in 10 years with all programs either eliminated or redirected to support the private sector; and
- We should also preempt future efforts at increasing defense expenditures by pointing out the absurdity of conscription, especially when associated with an alternative national service requirement for all males, instead of concentration on providing better health and education services.

C. Conclusion

Without a redefinition of government's role, based upon realistic assumptions of resources and absorptive capacity, Mozambique will be unable to effectively utilize its domestic and external resources. With declining foreign assistance, Mozambique does not have the luxury of trying to maintain the status quo. To take maximum advantage of its very real potential, the GRM must be persuaded to immediately take the steps required. For the economy that means empowering the private sector to become the real engine of growth; for absorptive capacity, that means structuring government according to available resources, both human and financial, and facilitating the greatest possible participation by Mozambicans.

VI. THE U.S. PLEDGE

A. The U.S. Assistance Program

In November 1994, Mozambique's first ever free and fair elections were held. This landmark event transformed Mozambique from decades of war and civil strife to an era with the potential for peace, security and economic growth. The challenge is to encourage the GRM to take the bold steps required to transform the uncertainties of the present into a more secure and stable future.

The 1996 Consultative Group meeting is a watershed event. At peace with all its neighbors, and with a high degree of domestic tranquillity if not consensus, the GRM should set its sights now on completing the dismantling of state management of the economy and boldly set the stage for economic freedom through open markets.

Our aid program should set as its principal goal, over the long-term, the achievement of sustained political and economic freedom in Mozambique. Only such an environment will contribute positively to increased growth, trade and economic cooperation in Southern Africa -- an important objective of U.S. foreign policy in this region.

For FY 1996, U.S. assistance retains important elements of our 1992-94 transition program, e.g., rehabilitation of rural infrastructure. We have put in place activities this fiscal year to support the Government's reconstruction effort, e.g., rural road construction, and expanding rural production, markets and incomes through programs implemented by PVOs and Mozambican NGOs.

Under the currently budgeted program, the USG will provide approximately $55 million to Mozambique. This total includes $35 million from the Development Fund for Africa, $9 million of Title III food aid, and $11 million of emergency food aid.

1. Country Strategic Plan

The Rural Access Project (656-0232) ($8 million) is supporting a strategic objective of increasing rural household income through improving market access by producers, traders and consumers. The PVO/NGO Support Project II(656-0229) ($13 million) is financing grants to PVOs and Mozambican NGOs to support initiatives in increasing household income, improving maternal and child health, and strengthening civil society. The Democratic Initiatives Project (656-0227) ($3.6 million) is providing assistance for the national assembly, municipal elections and the technical secretariat for elections, as well as support for civil society, legal sector reform and decentralization of government including examination of the role of traditional authorities. Additional funding will be provided for both long-term ($560,000) and short-term ($230,000) capacity building. Based on available

resources, the Market Food Aid Program ($9 million of P.L. 480 Title III resources) for FY 96 will continue to strive for policy reform while balancing food security concerns and concerns about disincentives to domestic production. The Mission is also providing a moderate ($2.2 million) addition to the Private Sector Support Program (656-0208), a policy-conditioned commodity import program. Three policy initiatives related to food security, land tenure security, and restoration of cashew production in the cyclone Nadia-affected areas of Nampula, are being financed through the Private Sector Support/Technical Assistance Project (656-0218) ($2.5 million).

In summary, U.S. development assistance for FY 96 is expected to be:

$3.6 million for civil society, legal sector reform and decentralization of government through enhancement of traditional authorities

$8 million for the rehabilitation and upgrading of roads and bridges essential for the recovery and development of market networks

$13.2 million for a variety of activities through PVO's to support all three strategic objectives

$2.2 million will be available for the commodity import program but will be deferred until a determination is made that necessary policy reforms have been achieved

$2.5 million to provide technical assistance in support of policy research related to food security, land tenure security and recovery of cashew nut production in the cyclone Nadia-affected areas of Nampula

$4.7 million for primary health care/child survival

$790,000 for human resource development in both the private and public sectors

$150,00 for strategy completion, program monitoring and program and project development

We anticipate providing food aid to Mozambique during FY 96 at the level of $9 million of P.L. 480 Title III resources, depending on the resolution of the issues concerning the stolen corn from the port of Maputo, and $11 million of P.L. 480 Title II.

B. Planned U.S. Assistance for FY 1997

In April 1995, the U.S. Mission submitted a proposed six-year strategy for the FY 1996-2001 period. In order to achieve sustained political and economic freedom in Mozambique, we are concentrating our assistance on increasing production and incomes in rural areas,

expanding the process of democratization and strengthening social services which contribute to productivity, e.g., health. We will continue important training programs in the areas of leadership development and technical skills training. Provision of commercial food aid will depend on the resolution of the issues concerning the stolen maize from the port of Maputo. Levels of humanitarian assistance will decline but continue as necessary. Commodity import financing will be expanded only if the government achieves measurable results in bringing about the policy changes and shifts in budgetary priorities necessary for economic development and political stability. Whether this program is sustainable will depend upon the actions taken by the GRM on economic reform and the availability of U.S. funds given pending U.S. budget reductions.

Drafter: Sallen:C:\MSOFFICE\WINWORD\CG

Clearances:

ADIR:JSmith_____ Date:_____

ATTACHMENTS

[1]*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.*

[22] For a detailed analysis of Mozambique's economy and the underlying constraints, see the Mission Economist's Economic Annex of the Country Strategy Plan.

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

NINTH MOZAMBIQUE CONSULTATIVE GROUP

U.S. PLEDGING STATEMENT

Madame Chairperson, Your Excellency Prime Minister Mocumbi, Distinguished Members of the Mozambican Delegation, Colleagues, Ladies and Gentlemen,

The 1996 Consultative Group Meeting is a watershed event. At peace with all its neighbors, and with a high degree of domestic tranquillity if not consensus, the Mozambican Government should set its sights now on completing the dismantling of state management of the economy and boldly set the stage for economic freedom through open markets.

For FY 1996, U.S. assistance retains important elements of our 1992-94 transition program, e.g., rehabilitation of rural infrastructure. We have put in place activities this fiscal year to support the Government's reconstruction effort, e.g., rural road construction, and expanding rural production, markets and incomes through programs implemented by PVOs and Mozambican NGOs.

Development assistance for FY 1996 is expected to be approximately $35 million and can be summarized as follows:

$3.6 million for civil society, legal sector reform and decentralization of government through enhancement of traditional authorities

$8 million for the rehabilitation and upgrading of roads and bridges essential for the recovery and development of market networks

$13.2 million for a variety of activities through PVO's to support all three strategic objectives

$2.2 million will be available for the commodity import program but will be deferred until a determination is made that necessary policy reforms have been achieved

$2.5 million to provide technical assistance in support of policy research related to food security, land tenure security and recovery of cashew nut production in the cyclone Nadia-affected areas of Nampula

$4.7 million for primary health care/child survival

$790,000 for human resource development in both the private and public sectors

$150,000 for strategy completion, program monitoring and program and project development

We anticipate providing food aid to Mozambique during FY 96 at the level of approximately $5 million of P.L. 480 Title III resources, depending on the resolution of issues concerning the corn

theft from the port of Maputo, and $13 million of P.L. 480 Title II. Levels of humanitarian assistance will decline but continue as necessary.

Our program strategy for the period FY 1996-2001 concentrates assistance on increasing production and income in rural areas, expanding the process of democratization and strengthening social services which contribute to productivity, e.g. health. Whether our future program is sustainable will depend on the actions taken by the Mozambican Government on economic reform and the availability of U.S. funds, given pending U.S. budget reductions.

Madame Chairperson, our aid program sets as its principal goal, over the long-term the achievement of sustained political and economic freedom in Mozambique. Only such an environment will contribute positively to increased growth, trade and economic cooperation in Southern Africa.

NINTH MOZAMBIQUE CONSULTATIVE GROUP

REVISED OPENING STATEMENT (DRAFT)

MADAME CHAIRPERSON, YOUR EXCELLENCY PRIME MINISTER MOCUMBI, DISTINGUISHED MEMBERS OF THE MOZAMBICAN DELEGATION, COLLEAGUES, LADIES AND GENTLEMEN.

AT LAST YEAR'S CG, MOZAMBIQUE WAS AT A CRITICAL JUNCTURE. IT HAD RECENTLY EMERGED FROM DECADES OF CIVIL WAR AND HAD JUST HAD ITS FIRST FREE AND FAIR ELECTIONS. WE ARE PLEASED THAT THE SECURITY SITUATION HAS REMAINED STABLE DURING 1995 AND THAT THE MORE THAN 90,000 DEMOBILIZED SOLDIERS HAVE BEGUN TO RE-ESTABLISH CIVILIAN LIVES. ILLUSTRATIONS OF MOZAMBICANS NEW-FOUND CONFIDENCE IN PEACE, FREEDOM AND THE FUTURE MOUNTED THROUGHOUT THE PAST YEAR: LIVESTOCK HOLDINGS CONTINUED TO VISIBLY INCREASE; CONSTRUCTION OF MORE PERMANENT HOUSING REPLACED INITIAL SHELTERS, SMALL SCALE CAPITAL INVESTMENTS SUCH AS GRAIN MILLS, SHOPS AND TRANSPORT SERVICES MULTIPLIED AND RURAL HOUSEHOLDS EXPANDED THEIR CULTIVATION AREAS. IMPROVEMENTS IN ACCESS AND MOBILITY OF THE POPULATION HAVE BROUGHT ALL AREAS OF THE COUNTRY INTO CONTACT AGAIN. WHILE HEAVY RAINS STILL TEMPORARILY DISRUPT TRANSPORT AND COMMUNICATIONS, THERE ARE NO LONGER ANY AREAS WHICH ARE COMPLETELY ISOLATED. THESE POSITIVE FACTORS AND THE PERSISTENCE

AND RESOURCEFULNESS OF THE MOZAMBICAN PEOPLE HAVE SET THE STAGE FOR MOZAMBIQUE'S POST-TRANSITION DEVELOPMENT. AS THE INITIAL PERIOD OF POST-WAR RECOVERY ENDS, MOZAMBIQUE IS WELL ALONG THE RELIEF-TO-DEVELOPMENT CONTINUUM. YET THERE ARE SOME SERIOUS, OVERARCHING CONCERNS WHICH THE U.S. AND OTHER DONORS FEEL MUST BE BETTER ADDRESSED TO KEEP MOZAMBIQUE MOVING TOWARD BECOMING A MORE FREE AND PROSPEROUS COUNTRY.

THE U.S. APPLAUDS THE GOVERNMENT'S STATED COMMITMENT TO A COURSE OF PRIVATE SECTOR LED, MARKET-ORIENTED DEVELOPMENT OF MOZAMBIQUE'S ECONOMY AND TO INCREASING SOCIAL SECTOR OUTLAYS WHILE DECREASING DEFENSE SPENDING. WE CALL UPON MOZAMBIQUE TO SET AS ITS OBJECTIVE THE ELIMINATION OF DEPENDENCE ON EXTERNAL ASSISTANCE WITHIN TEN YEARS AND ITS REPLACEMENT BY DOMESTIC RESOURCE MOBILIZATION, EXPORT EARNINGS AND FOREIGN DIRECT INVESTMENT.

HOWEVER, SUBSTANTIAL OBSTACLES REMAIN TO BE OVERCOME IF MOZAMBIQUE IS TO ACHIEVE RAPID SUSTAINABLE ECONOMIC GROWTH.

LAST YEAR, THE GOVERNMENT AND DONORS WERE GRAPPLING WITH THE CONCEPTUAL FRAMEWORK FOR REFORM. THIS YEAR, THE OUTLINE OF WHAT NEEDS TO BE DONE IS MORE CLEAR AND UNANIMOUSLY AGREED. IN A CLIMATE OF DECLINING ASSISTANCE RESOURCES WORLDWIDE, THE URGENCY OF IMPLEMENTING THE MEASURES THE GOVERNMENT AND

DONORS HAVE AGREED ON IS CRITICAL. WE WELCOME THE PROGRESS BEING MADE TO PRIVATIZE THE STATE-OWNED BANKS AND CUSTOMS. WE HOPE THE GOVERNMENT WILL PUT GREATER EMPHASIS AND MORE URGENCY ON TACKLING OTHER KEY ELEMENTS OF THE AGREED-UPON AGENDA.

LAST OCTOBER, DONORS APPEALED TO THE MOZAMBICAN GOVERNMENT TO PROCEED WITH A PROGRAM THAT ADDRESSED TAX AND CUSTOMS REFORM, FINANCIAL SECTOR REFORM, PRIVATE SECTOR DEVELOPMENT, AND CORRUPTION. IN THIS CONTEXT, DONORS URGED THE IMF TO BE FLEXIBLE IN ITS NEGOTIATIONS ON THE THIRD ESAF BUT ONLY IF MOZAMBIQUE'S PERFORMANCE WARRANTED SUCH FLEXIBILITY.

WHILE WE RECOGNIZE THE PROGRESS TO ADDRESS GOVERNMENT CAPACITIES AND REFORM GOVERNMENT EXPENDITURES, WE ARE CONCERNED THAT THE PRIVATE SECTOR SEEMS ALMOST AN AFTER-THOUGHT IN THE GOVERNMENT'S DOCUMENT: THE ENABLING CLIMATE FOR PRIVATE SECTOR INVESTMENT, DOMESTIC OR FOREIGN, HAS YET TO BE CREATED; TAX REFORM PROPOSALS HAVE TO BE SPECIFIC; AND THE GOVERNMENT HAS TO PROVIDE DETAILS ON HOW IT PLANS TO TACKLE MAJOR BOTTLENECKS TO GROWTH LIKE AN INEFFICIENT TRANSPORT SECTOR, AND STATE-RUN ENTERPRISES WHICH MAKE THE COST OF DOING BUSINESS IN MOZAMBIQUE PROHIBITIVE.

THE GOVERNMENT NEEDS TO MOVE FORTHRIGHTLY TO TACKLE THE

QUESTION OF CORRUPTION. THERE IS UNIVERSAL AGREEMENT THAT THE PROBLEM IS WORSENING: OUR OWN EXPERIENCE WITH THE THEFT OF ALMOST NINETEEN HUNDRED TONS OF YELLOW MAIZE IN DECEMBER 1995 IS ONLY THE MOST PUBLIC OF THE MANY EXAMPLES OF CORRUPTION IMPACTING ON GROWTH AND ECONOMIC REFORM POLICIES IN MOZAMBIQUE. THE COST IS VERY REAL: AS A RESULT OF THE MAIZE THEFT, THE GOVERNMENT LOST $4 MILLION BECAUSE THE U.S. SUSPENDED ITS P.L. 480 TITLE III PROGRAM, WHICH WOULD HAVE GENERATED DESPERATELY NEEDED COUNTERPART FUNDS. FUTURE PROGRAMS FOR COMMERCIAL FOOD ASSISTANCE ARE NOW IN JEOPARDY. OTHER DONORS ARE RECONSIDERING BALANCE OF PAYMENTS SUPPORT AND ASSISTANCE TO SPECIFIC SECTORS. UNCONTROLLED AND UNSECURED LENDING TO SPECIAL INTERESTS BY BCM AND BPD DIRECTLY CONTRIBUTED TO LAST YEAR'S HIGH INFLATION RATE. SOME PRIVATIZATIONS HAVE BEEN CARRIED OUT TO THE BENEFIT OF SHADOW RATHER THAN REAL MOZAMBICAN COMPANIES WHICH FAIL TO INVEST PRODUCTIVELY. AND AS LAND TENURE REFORM IS PUT ON HOLD, LAND GRANTS ARE BEING MADE TO THOSE WITH THE CONNECTIONS TO SECURE THEM WITHOUT ANY REGARD TO THE CRITICAL NEED TO REVITALIZE MOZAMBICAN AGRICULTURE.

WE ARE ALSO ESPECIALLY CONCERNED ABOUT THE CREDIBLE ALLEGATIONS OF HIGH-LEVEL INVOLVEMENT IN FACILITATING DRUG

TRAFFICKING IN MOZAMBIQUE AND THE FAILURE OF THE JUDICIAL SYSTEM TO BRING ANYONE TO JUSTICE. WITHOUT STRONG GOVERNMENT MOVEMENT ON THIS PROBLEM, NARCOTICS COULD NOT ONLY DESTROY THE FABRIC OF MOZAMBICAN SOCIETY BUT ALSO THE CREDIBILITY OF ITS GOVERNMENT AS WELL.

THE IMPACT OF CORRUPTION IS CLEARLY AFFECTING THE PROSPECTS OF ECONOMIC RECOVERY AS SCARCE RESOURCES ARE SIPHONED OFF AND USED UNPRODUCTIVELY. THEY THREATEN THE COUNTRY'S ABILITY TO ATTRACT FOREIGN INVESTORS AT THE VERY TIME MAJOR PROJECTS ARE IN THE WORKS THAT NEED SUBSTANTIAL FOREIGN INVESTMENT TO SUCCEED. THE GOVERNMENT RISKS LOSING SIGNIFICANT DONOR SUPPORT IF CORRUPT PRACTICES ARE NOT CURTAILED. THE EFFECTIVE IMPLEMENTATION OF STRUCTURAL ECONOMIC REFORMS IN BANKING, TAXES, AND CUSTOMS THAT THE GOVERNMENT IS PROPOSING COULD GO A LONG WAY TOWARDS CURTAILING CORRUPTION.

TACKLING INFLATION AND FINANCIAL SECTOR REFORM IN THE CONTEXT OF AGREEMENTS WORKED OUT BETWEEN THE IMF AND THE MOZAMBICAN GOVERNMENT REMAINS CRITICAL. WE REMAIN CONCERNED THAT INFLATION WILL NOT BE CONTROLLED, MONETARY POLICY WILL NOT BE EFFECTIVE, AND FINANCIAL SECTOR REFORM WILL BE JEOPARDIZED AS LONG AS THE TWO STATE-OWNED COMMERCIAL BANKS ARE NOT PRIVATIZED. WE RECOMMEND THAT PRIVATE BANKING SPECIALISTS BE

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PLACED IN BPD IMMEDIATELY TO MONITOR CREDIT, CASH, AND FOREIGN EXCHANGE OPERATIONS, AND THAT IF PRIVATIZATION TARGETS ARE NOT MET, THE GOVERNMENT IMMEDIATELY BEGIN LIQUIDATION PROCEEDINGS.

WE SUPPORT GREATER SPECIFICITY IN THE TAX AND CUSTOMS REFORM PROPOSALS, WHICH SHOULD INCLUDE ELIMINATION OF NUISANCE TAXES LIKE THE STAMP TAX, A LOW AND UNIFIED TARIFF STRUCTURE, A SIMPLIFIED TAX CODE, AND EXEMPTIONS FROM ALL TAXATION FOR SMALL-SCALE AGRICULTURE AND SMALL AND MEDIUM ENTERPRISES.

FOREIGN INVESTMENT, WHICH REMAINS AT UNACCEPTABLY LOW LEVELS, WOULD BE ENCOURAGED BY THESE CHANGES AS IT WOULD BE BY THE REMOVAL OF REGULATORY CONSTRAINTS, AND THE DEREGULATION OF THE TRANSPORT, TELECOMMUNICATIONS, AND ENERGY SECTORS.

WE WELCOME THE GOVERNMENT'S DECLARED INTENTION TO TRANSFORM THE CENTER FOR THE PROMOTION OF INVESTMENT AND ELIMINATE ITS REGULATORY PRACTICES WHICH CONTINUE TO INHIBIT INVESTMENT. EVEN SMALL CHANGES (SUCH AS ELIMINATION OF VISA REQUIREMENTS AND THE PROHIBITION AGAINST TAKING METICAIS OUT OF THE COUNTRY) COULD BRING ABOUT A LARGE IMPROVEMENT IN THE IMAGE OF MOZAMBIQUE AS A VIABLE PLACE TO DO BUSINESS. WE ALSO HOPE THAT CFM, LAM, AND PETROMOC CAN BE PRIVATIZED THIS YEAR.

THE LACK OF TRANSPARENCY IN BUDGET EXPENDITURES REMAINS A SERIOUS CONCERN. WE SUPPORT THE GOVERNMENT'S IMPLEMENTATION

OF THE BUDGET FRAMEWORK LAW AND SYSTEM OF CLASSIFICATION WHICH SHOULD GREATLY INCREASE TRANSPARENCY AND ACCOUNTABILITY.

I WOULD LIKE TO REAFFIRM OUR COMMITMENT TO ASSISTING MOZAMBIQUE. OUR COMMENTS ARE OFFERED AS CONCERNED PARTNERS LOOKING FOR WAYS TO SPEED GROWTH, STABILITY, AND DEVELOPMENT. IN ORDER TO SUSTAIN OUR PROGRAM AT A TIME OF MASSIVE AID CUTS IN WASHINGTON, HOWEVER, WE NEED THE GOVERNMENT'S COMMITMENT TO SPECIFIC REFORMS TO BE CLEAR AND UNAMBIGUOUS. I CALL UPON MOZAMBIQUE AND ALL OF US IN THE DONOR COMMUNITY TO SET AS OUR MUTUAL OBJECTIVE THE ELIMINATION OF DEPENDENCE ON EXTERNAL ASSISTANCE WITHIN TEN YEARS -- TO BE REPLACED BY DOMESTIC RESOURCES, EXPORT EARNINGS, BETTER TAX COLLECTION, AND FOREIGN INVESTMENT.

MADAME CHAIRPERSON, OUR PROGRAM FOR FY 1996 RETAINS IMPORTANT ELEMENTS OF CONTINUITY WITH THE ASSISTANCE WE HAVE PROVIDED IN PREVIOUS YEARS. WE ARE CONTINUING TO FUND PROGRAMS FOR THE REHABILITATION OF RURAL INFRASTRUCTURE AND THE DEVELOPMENT OF AGRICULTURAL MARKETS. WE PLAN TO CONTINUE EMERGENCY FOOD AID. THESE PROGRAMS CAN HELP STIMULATE PRODUCTION, MARKETS AND RURAL INCOMES GROWTH. OUR PROGRAMS FOR FY 1996 WILL ALSO HAVE A STRONGER HEALTH COMPONENT ORIENTED TOWARDS MATERNAL AND CHILD SURVIVAL. A CRITICAL ELEMENT OF OUR

ASSISTANCE REMAINS IN THE FIELD OF DEMOCRATIZATION, WHERE WE WILL CONTINUE TO ASSIST THE NATIONAL ASSEMBLY, THE INDEPENDENT MEDIA, DECENTRALIZATION, AND LOCAL ELECTIONS IN 1997.

UNDER THE CURRENTLY BUDGETED PROGRAM, THE USG WILL PROVIDE APPROXIMATELY $53 MILLION TO MOZAMBIQUE THIS YEAR. THIS TOTAL INCLUDES APPROXIMATELY $35 MILLION FROM THE DEVELOPMENT FUND FOR AFRICA AND $18 MILLION FOR BOTH COMMERCIAL AND EMERGENCY FOOD AID. AS I HAVE POINTED OUT, THE COMMERCIAL FOOD AID PROGRAM IS IN JEOPARDY UNTIL THE RESOLUTION OF ISSUES CONCERNING THE USAID MAIZE WHICH WAS PART OF OUR TITLE III PROGRAM.

IN CLOSING, I WOULD LIKE TO REITERATE MY APPEAL FOR A VISION OF HOW RAPID ECONOMIC GROWTH AND ELIMINATION OF DEPENDENCY ON EXTERNAL ASSISTANCE CAN BE ACHIEVED WITHIN A DECADE. MOZAMBIQUE'S GOVERNMENT, ITS PEOPLE, DONORS, AND INVESTORS CAN BECOME PARTNERS IN A BOLD, INNOVATIVE UNDERTAKING TO ACHIEVE THAT BRIGHTER FUTURE. WE HOPE THIS CG TAKES US ALL CLOSER TO OUR COMMON GOAL.

APRIL 2, 1996

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