

ce. 5560-mz
D005-mz

REPUBLIC OF MOZAMBIQUE
MINISTRY OF PLANNING AND DEVELOPMENT
OFFICE OF THE MINISTER

Ofício nº 238/MPD/GM/ /2014

Maputo, November 04, 2014

Subject: Letter of Development Policy for the Tenth Poverty Reduction Support Credit (PRSC 10)

Dear Mr. Lundell,

1. I am writing on behalf of the Government of the Republic of Mozambique to request the Tenth Poverty Reduction Support Credit (PRSC 10) in the amount of US\$ 110 million from the International Development Association (IDA), to support the implementation of country's Action Plan for Poverty Reduction (PARP), which was endorsed by the Council of Ministers in 2011 and will end implementation in 2015.
2. We would like to commend your commitment to supporting our efforts to reduce poverty over the years and your active participation in the group of donors that coordinate their budget support to Mozambique through the G19.
3. The objective of the PARP is to combat poverty and promote a culture of work, with a view of achieving inclusive economic growth and reducing poverty and vulnerability in Mozambique. This is in line with the objectives of this operation, which is to support government efforts to improve the business environment, strengthen social protection and enhance public finance management. These objectives will contribute to the achievement of PARP objectives and help Mozambique end extreme poverty and promote shared prosperity.

To:
Mr. Mark Lundell
Country Director for
Mozambique, Madagascar, Mauritius, Comoros e Seychells
The World Bank
Maputo

A handwritten signature in black ink, appearing to be "J.", located at the bottom right of the page.

4. The PRSC ID has been designed within the context of the Memorandum of Understanding (MoU) between the Government of the Republic of Mozambique and the international aid partners, including the World Bank Group, signed in March 2009. The MoU outlines the participant's approach to the provision of budget support, among other related measures.

Macroeconomic context

5. Mozambique's economy remains robust, with growth estimated at 7.4 percent in 2013 and at 6.9 percent in the second quarter of 2014, supported by the expansion of agriculture, extractive industries and services sectors. The economy recovered from the devastating floods in early 2013. Extractive industries continue to be the most dynamic sector in the economy, although growth has moderated in 2014, affected by weaker commodity prices and infrastructure constraints. Agriculture continues to be the economy's largest sector at 28 percent of GDP and it employs 80 percent of the labor force. We expect developments in the mining and petroleum sectors to transform Mozambique's economy in the medium term, with coal production and exports, the implementation of large infrastructure investments, including in LNG plants, greater dynamism in the construction and transport sectors as well a revival of agricultural growth to contribute to annual growth of 7-8 percent.
6. Year on year inflation at the end of 2013 was 3 percent. By August 2014 it had declined to 1.8 percent. Low inflation and a weak external environment enabled the Central Bank to ease monetary policy and policy rates are at a record low of 8.25 percent. These efforts have had limited impact on market rates that remain high. Credit growth has accelerated only slowly given a weak monetary transmission mechanism. We expect inflation between 5 and 6 percent of GDP over the next few years and we will continue to monitor inflation and proactively coordinate fiscal and monetary policies. Monetary policy will remain oriented toward achieving the objectives of keeping inflation low and stable, safeguarding the financial system and encouraging lending. We will continue reforms to improve operations in the financial system and broaden access to financial services.
7. Regarding fiscal policy, tax revenues have grown at a rapid pace, rising from 17 percent of GDP in 2011 to a projected 23 percent in 2014, reflecting efforts to improve tax administration and high capital gains taxes from the emerging extractives industries. This increase in domestic resources has compensated for a decline in aid flows, which in 2013 financed less than 30 percent of expenditures. Public spending reached 35 percent of GDP in 2013 and is projected at 43 percent in 2014. The increase in spending is a result of a number of one-off expenditures (around 3 percent of GDP) such as post-floods reconstruction, the 2014 general elections as well as large investments in defense equipment. Capital spending has also increased significantly over the past few years as we try to close the huge infrastructure gap in the country. The recent reforms to the electoral bodies, part of discussions held with opposition party Renamo to end a violent conflict, also had fiscal implications that needed to be accommodated in the 2014 budget. To be able to accommodate these additional costs as well as additional revenue from capital gains taxes parliament passed a revised

budget in August 2014. The overall deficit (after grants) in 2014 will be 10 percent of GDP. The Government is aware that this high deficit is not sustainable and will be tightening fiscal policy starting in 2015.

8. The new government will prepare a budget and submit it to parliament early next year. We have prepared a budget proposal to inform deliberations of the next government. In this budget proposal, in 2015 government revenue would decline to 25 percent of GDP and we expect grants in the order of 4 percent of GDP. Expenditure would decline as a share of GDP to 37 percent, resulting in an overall balance after grants of 7.9 percent of GDP, which represents a decline of 2.1 percentage points of GDP. This consolidation effort will be possible due to the end of one-off expenditures in 2014, growth in investments and recurrent spending that is slower than nominal GDP and concerted efforts to contain wage bill increases. At the same time, the government is seeking to accommodate additional activities to strengthen the peace agreement reached in 2014 with significant fiscal implications. Going forward, we will continue with efforts to contain public spending growth and we would expect spending to fall to 35 percent of GDP by 2017, resulting in an overall balance (after grants) of 6.4 percent of GDP. These efforts will ensure that the country maintains fiscal and macroeconomic stability which has been one of the cornerstones of our positive growth trajectory over the past few decades.
9. Over the past few years we have also seen a significant widening of the current account deficit, as the country benefited from significant FDI inflows. A large share of these inflows was destined for extractive industries, which by nature are often capital- and import intensive. The current account deficit widened to US\$6 billion in 2013 or 39 percent of GDP. We expect the deficit to widen in the next few years to around 45 percent of GDP, as we continue to benefit from large FDI inflows and invest in developing the country's extractive industries and ancillary infrastructure. As the construction phase comes to an end and exports of mining and gas accelerate toward the end of the decade, we expect the current account deficit to quickly narrow. Despite this large deficit, the balance of payments has been positive over the past few years and our reserve position continues to improve, with reserves reaching US\$3.2 billion by end 2013, or over 4 months of imports (excluding mega project imports).
10. Mozambique has dramatically increased infrastructure investments over the past few years and now has one of the highest investment levels in Africa. These investments will allow us to grow faster in the future and ensure that the benefits of growth are widely shared among the population. A share of this scaling up in investment has been financed by debt. As a result, public debt has grown over the past few years, from 37 percent of GDP in 2011 to 52 percent in 2013. A growing share of this debt was contracted on non-concessional terms for projects that will generate significant financial returns. Debt remains sustainable, as suggested in the latest joint WB-IMF debt sustainability analysis (DSA) for Mozambique prepared in mid-2014, although the risk rating has increased from low to moderate. We expect the rate of growth of debt to decline in the near term, as we moderate the increase in borrowing. In addition, we are strengthening systems to manage a



more complex financing mix and public investment portfolio, and some of those reforms are supported by this operation.

Implementation of the Poverty Reduction Strategy

11. We are committed to sustain our pursuit of more inclusive growth during and beyond the current Action Plan for Poverty Reduction that will continue to guide our interventions until 2015. The PARP aims to induce patterns of inclusive growth by increasing the allocation of funds for investment under the following pillars: (i) enhancing production and productivity in agriculture and fishing; (ii) creating employment; and (iii) enhancing social and human development. A review of its quantified indicators is underway to refine them, make them more relevant for assessing progress toward strategic aims, and ensure that they are all measurable and adequate for the new development challenges.
12. Enhancing production and productivity in agriculture. Agriculture employs 78 percent of the economically active population and contributes 23 percent to GDP. Thus productivity increases and the expansion of areas under cultivation are key to improvements in the livelihood of the population. To this end, we have adopted an agricultural sector development strategy (PEDSA) for 2011-20 and just launched an agricultural investment plan (PNISA) 2013-17 that will help to gradually shift production from subsistence to commercial farming. We have also introduced new regulations for the production of seeds and fertilizers. As a result, we have seen significant progress in our objective of increasing agricultural productivity. During 2013 15 percent of farmers were assisted by extension services to adopt new technologies. The area with rehabilitated irrigation infrastructure reached 5,800 ha and 73 percent of all roads are considered to be in good condition.
13. Creating employment. The ability of the private sector to create productive employment will be crucial in our efforts to ensure that growth is inclusive. We have adopted a new strategy for the Improvement of the Business Environment 2013-17 (EMAN II) and are working with a series of development partners, including the World Bank Group, to implement the interventions included in this strategy. We have recently approved a long term development strategy for the country (Estratégia Nacional de Desenvolvimento) which seeks to guide development in Mozambique over the next 20 years to improve the wellbeing of the population through structural transformation and expansion and diversification of the productive base. As a result of these efforts we have continued to strengthen vocational training and improved opportunities for SMEs in public tenders. In all, 270,267 formal sector jobs were created: 92,140 in the public sector and 178,127 in the private sector.
14. Enhancing social and human development. Efforts to boost primary school enrolment continued. The net school enrollment rate at age 6 in first grade increased to 77 percent. Significant strides in this regard have been the creation of an increasingly gender-equitable system, particularly in secondary schools, and progress in monitoring and evaluating student performance in primary schools. In the health sector, the 2012-16 Health Strategy and the Monitoring and Evaluation plans

were adopted recently, which aim to push forward improvements in the still relatively weak public health system. We launched the Action Plan for Pharmaceutical Logistics and finalized the Pharmaceutical Logistics Strategy as a means to deal with the drug logistics crisis and emergency that had arisen in 2011. PFM systems in the sector have also strengthened with bi-monthly monitoring of the sector accounts. Development outcomes show some progress across a range of sectors, including an increase of assisted deliveries from 65 to 69 percent, an increase in the number of households benefitting from social assistance from 344,000 to 365,000 as well as an increase in the number of water sources in rural areas from 19,000 to over 23,000.

Recent and planned reforms in this operation

15. This operation will support a number of reforms in three areas that are crucial for the achievement of the development objectives outlined in the PARP: (i) to foster economic development, (ii) to strengthen social protection and (iii) to improve public finance management. The specific reforms implemented over the last year include:

Economic Development – Investment Climate

16. As part of our efforts to improve the business and investment climate, we have been working with the World Bank group to simplify licensing requirements in a number of areas and streamlining procedures for starting a new business. In 2013 we revised the commercial and tourism licensing regulations that will reduce the number of days that businesses need to obtain these licenses as well as the administrative costs associated with the process. In 2014 we have revised the industrial licensing regulations which will dramatically reduce the amount of time required to issue industrial licenses. In 2014 we have also adopted a single form for opening a new business and starting activities. The single form consolidates a number of processes that were formerly separate, and private firms may now submit all required information at the government's "one-stop shop" for business registration. This is expected to cut by half the number of steps required for regulatory compliance. The One-stop shops are being piloted in six Mozambican cities and we expect it to be expanded to the rest of the country next year.

Economic Development – Management of Extractive Industries

17. The Government is accelerating efforts to strengthen both our systems and regulatory environment to be able to manage the country's extractive industries, which are likely to become an engine of growth and, if well managed, bring significant benefits to the population. The national assembly passed recently four crucial pieces of legislation for the management of extractive industries. The mining law and the fiscal regime for mining will govern the management of the sector and also determine the sharing of rents between investors and the public. The petroleum law and the fiscal regime for petroleum will do the same for the petroleum sector. The debate around these pieces of legislation has been very lively and the legislation passed reflects the compromises that have been reached to bring the maximum benefit to the people of Mozambique. In the next few

months we need to pass implementing regulations for the mining and petroleum law as well as prepare a decree law that will govern LNG investments and operations in the Rovuma basin. This legislation will pave the way for final investment decisions by investors in the Rovuma basin and the start of the LNG plants construction.

18. We are also aiming to maximize transparency in the way the country manages extractive industries. We remain compliant with the EITI, the last report was published in March 2014 and we will increase our efforts to ensure that the next report, to be published by the end of 2014, confirms our compliance with the new EITI status. The majority of contracts with investors in the extractive industries were also made public online at the beginning of this year and we continue to share a portion of the production taxes paid by extractive industries with affected communities to ensure that the benefits of these industries are also felt by those closest to the large investments taking place. In 2013 we allocated 2.75 percent of production taxes to seven producing districts. We continued with these transfers in 2014. The transferred amounts are to be used by communities to invest in community infrastructure such as schools, health centers, markets or bridges. As this is a new initiative and the country has had to tackle significant volatility in the volumes of production and prices of its extractive industries, there have been some delays in the transfers and execution of projects. We have been working with your institution to better understand the strengths of this initiative and how it can be improved and we expect to make the necessary adjustments in the near future to ensure affected communities continue to benefit from these transfers.

Social Protection

19. A large proportion of Mozambique's population is highly vulnerable to shocks. These include structural food insecurity during the annual agricultural cycle, unpredictable changes in food prices, and a range of natural disasters. As a way of supporting the poor and vulnerable, the Government is seeking to improve and expand its social assistance programs. Many social assistance programs are administratively or geographically fragmented, have low overall coverage, or are not well targeted. In the past few years benefits have been made more generous and the coverage of the social protection programs have been widened, but we still have some work to do. As we continue to allocate additional resources to these key programs, we will need to establish more effective mechanisms for selecting, recording and organizing beneficiaries in order to allocate and manage funds effectively.
20. Recognizing these challenges, the government has launched a comprehensive initiative to strengthen the legal and institutional framework for social protection. The Social Protection Law, passed in 2007, establishes the legal foundation and institutional structure for the social protection system. In 2009 the government launched the National Strategy for Basic Social Security (Estratégia Nacional de Segurança Social Básica—ENSSB). The government is currently working to evaluate and to design the new ENSSB which include possibility to indicate new programs. The Basic Social Subsidy Program (Programa de Subsídio Social Básico—PSSB), a cash transfer program, targets extremely poor households in which no adult is able to work. The Productive Social Action

Program (Programa de Acção Social Productiva—PASP), focuses on extremely poor households in which one or more adults are able to work, but face limited employment opportunities or low income prospects. The PASP is designed to boost incomes among its beneficiaries through direct employment in public works projects, and by providing training programs and other educational opportunities.

21. The PSSB and the PASP would provide support to about 800,000 extremely poor vulnerable households in rural and urban areas once full implementation was reached. The first phase of the PASP is currently being implemented and the program will begin scaling up in January of 2015. The PSSB and PASP are complemented by the Direct Social Action Program (Programa de Apoio Social Directo—PASD), which provides short-term support to households that are temporarily vulnerable or have been affected by an acute shock. The government has increased the budget allocation for social protection programs. Spending on social protection has almost tripled since 2008, rising from around US\$13 million to an allocation in 2014 of US\$85 million, or 0.5 percent of GDP.
22. The government's strategy is based on the principle that different vulnerabilities require different interventions, but that these should be based on a common targeting system that identifies and registers beneficiaries in a single database. Implementing effective and well-coordinated social security policies requires an accurate, comprehensive and regularly updated registry of beneficiaries. INAS has developed a single registry covering all beneficiaries of basic social assistance programs, starting with those enrolled in the PSSB, PASD and PASP. INAS also adopted a revamped targeting process that groups beneficiaries by region, community and household. The single registry of beneficiaries will be fully functional next year, after INAS has registered all potential beneficiaries, and the system will be ready to be used by the social safety net programs next year.
23. To strengthen the efficiency and integrity of social protection programs the government will partner with private firms to distribute cash benefits. Contracting private firms to execute payments, including banks and telecom companies that operate mobile funds-transfer systems, will help to ensure that cash benefits are timely, predictable, transparent and secure. The government has already designed the new payment distribution system and launched a tender to select an appropriate operator. The new system is expected to be operational by 2015 and result in a significant increase in the share of beneficiaries that receive their payments on time.

Public Finance Management

24. As part of our efforts to enhance the effectiveness of public expenditure, we are strengthening systems to manage public investments and continue with efforts to enhance the management of debt and fiscal risks. As the country starts to benefit from increasing revenues from extractive industries, which may grow exponentially toward the end of the decade, it is particularly important to strengthen government systems to ensure that a larger resource envelope translates into improved provision of public goods and services and that we are able to reinvest rents from the

extractive industries and transform natural capital into physical and human capital, laying the foundation for robust economy-wide growth.

25. As we continue with our efforts to close the large infrastructure gap to remain competitive and ensure widespread enjoyment of the benefits of growth, we are increasing efforts to strengthen our systems to manage public investments to ensure the implemented projects have the expected returns. As part of those efforts the Government last year adopted the Integrated Investment Program (Programa Integrado de Investimento—PII). The PII will strengthen the ability of government agencies to appropriately sequence public investments by prioritizing investments over both the short and medium term based on a 3-year rolling basis. The objectives of the PII are to (i) improve the country's economic integration, (ii) increase agricultural productivity, (iii) improve logistics and access to markets, (iv) economic diversification, and (v) improved quality of social services infrastructure. The PII is revised each year, and updated projections of investment costs and benefits will be used to inform the debt management strategy and the medium term fiscal framework. A revised PII is currently being prepared, which will include summary information of all investment projects included in the PII. The PII also improves transparency in the decision making process by making public the type of information that has led to public investment decisions. The PII will also keep stakeholders in the private sector and civil society informed of the government's investment strategy, while also raising awareness of the benefits of individual projects.

26. As part of our efforts to improve our public investment management systems, we are also strengthening institutional structures, methodologies to appraise and evaluate projects and building the capacity of our staff. In March 2011 the government established the Public Project Coordination and Selection Committee (Comité de Coordenação e Selecção de Projectos Públicos, CCSPP), an organ of the Ministry of Planning and Development that advises government on the prioritization and selection of public investment projects. The CCSPP is chaired by a representative of MPD and includes staff from MoF and infrastructure-related sector ministries. The Government prepared and adopted a Manual for the Appraisal and Evaluation of Public Projects to guide project preparation and establish a standard set of criteria for assessing project proposals. MPD and MoF recently revised the methodology to prepare the Medium Term Fiscal Framework making project appraisal and evaluation mandatory for all public investments in excess of US\$5 million. We have conducted a series of capacity building workshops over the past few years to build the capacity of government staff in project appraisal and evaluation and intend to continue doing so. The recently approved Mozambique Integrated Growth Poles Project from the World Bank includes a component that will provide public investment management-related capacity building activities and technical assistance to the Government, which will focus on project planning, proposal evaluation and implementation monitoring. This is a long-term reform that will change in fundamental ways how we operate, and we look forward to continue working with your institution as we continue to implement this reform.

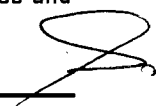
27. We are also seeking to strengthen our ability to manage debt and fiscal risks, as a large share of the new infrastructure investments are being financed through debt or financing mechanisms that

may increase fiscal risks. Improved management of debt and fiscal risks will allow us to continue implementing our ambitious infrastructure investment plan without compromising fiscal sustainability. In March 2011 the government established the Public Debt Management Committee (Comité de Gestão da Dívida Pública—CGDP). The CGDP is a consultative and advisory body in MoF; it is coordinated by the National Directorate of the Treasury and includes staff from MoF, MPD and BdM. The World Bank and IMF are providing technical assistance to the government to improve its debt management capacity. These efforts include the Financial Sector Technical Assistance Project, launched in 2005, and the joint Debt Management Facility program. We prepared our own Debt Sustainability Analysis in 2011, supported by both IMF and World Bank staff, an exercise we repeated in of 2012. We also adopted in 2012 an enhanced Medium-Term Debt Management Strategy for 2012-15, will guide the government's borrowing practices.

28. As part of our efforts to improve debt management, we formulated our first annual domestic borrowing plan in 2013 which we have successfully implemented. This will improve internal planning and communication with private capital markets. Following the experience of 2013, in early 2014 we issued the second annual domestic borrowing plan. We have also improved transparency and communication through the issuance of quarterly debt reports, which began in late-2011. We will revise the Medium Term Debt Management strategy next year.
29. As we seek to finance a share of infrastructure investment in partnership with the private sector, through PPPs or investments by SOEs, we will have a more complex financing mix which we will need to manage. Improved fiscal risks management is one of the areas that we will focus on in the near future, as suggested by the Fiscal Transparency Assessment that we asked the IMF to conduct in 2013. This assessment will inform the reform program going forward. We also recognize that the type of information in budget documentation on fiscal risks could be improved, which we will seek to do in the medium term. Our efforts will be supported by the establishment of a new fiscal risks unit in the Ministry of Finance. We are working with your institution for the design of this new unit, but we expect the new unit to, among other responsibilities, analyze the implications of government guarantees, public enterprises, and public-private partnerships. Over the medium term this unit would be responsible for preparing a comprehensive statement of fiscal risks to be included in annual budget documents. We are also working to strengthen the financial oversight of public enterprises and passed legislation and implementing regulations to that effect recently. We are also preparing a new law to govern the corporate sector of the state which we expect to send to parliament next year.

Activities undertaken in 2014

30. The PRSC-10 will support the following prior actions already completed by the Government of Mozambique to achieve results in the reform aims discussed above:
- a) The Council of Ministers has approved the Industrial Licensing Decree
 - b) The government has issued a decree adopting the single form for opening a new business and starting activities



- c) The Council of Ministers has approved a draft Fiscal Regime for the Hydrocarbons Sector and submitted it to the National Assembly
- d) INAS has developed and adopted a single registry of beneficiaries for all INAS programs providing cash as benefits
- e) INAS has designed a new payment distribution system and launched a tender to select an appropriate operator for the payment distribution system.
- f) The Ministry of Planning and Development and the Ministry of Finance have issued a revised methodology for the elaboration of the Medium Term Fiscal Framework making project appraisal and evaluation mandatory for all public investments in excess of US\$5 million.
- g) The government of Mozambique has adopted and published the Integrated Investment Program
- h) The Ministry of Finance has completed, published and implemented the first annual domestic borrowing plan based on the Medium-Term Debt Management Strategy
- i) The Council of Ministers has approved the implementing regulations for the Law on Public Enterprises

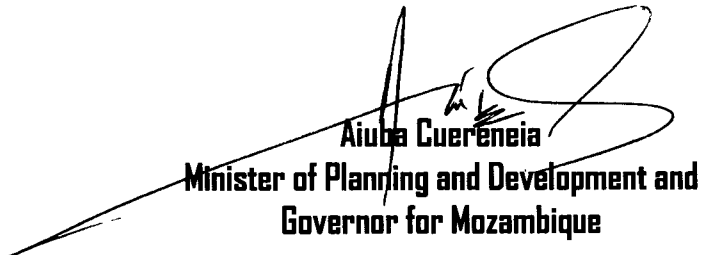
Prospects for 2015

31. Next year, we also expect to complete a number of policy actions that will further reforms in the areas covered by this operation. The policy actions that we expect to complete in 2015 are the following:
- a) The government introduces the e-BAU, an integrated IT platform to further streamline business start-up procedures.
 - b) Mozambique has achieved compliance with the new and revised standards of the Extractive Industries Transparency Initiative (as approved on May 2013).
 - c) The Council of Ministers approves the implementing regulations for the revised Mining Law
 - d) The Council of Ministers approves the implementing regulations for the revised Hydrocarbons Sector Law.
 - e) The government revises the system by which it transfers a share of the production taxes to communities and its use based on the experience accumulated.
 - f) INAS registers all beneficiaries of the PASP in the Single Registry of Beneficiaries (SRB).
 - g) INAS adopts the formal payment system for all the PASP beneficiaries and all new PSSB beneficiaries.
 - h) The Ministry of Planning and Development publishes (online) summary description of projects approved by the Council of Ministers, following the guidelines for project appraisal and evaluation.
 - i) The Ministry of Finance revises, the Medium Term Debt Management Strategy for 2014-2017 based on cost and risk analysis and relying on reliable debt data file generated by the debt management system.
 - j) The government clarifies the scope of the public sector, including a better definition of public funds and autonomous entities.

Conclusion

32. To conclude, we would like to highlight the Government's commitment towards promoting inclusive growth and poverty alleviating, as demonstrated by the reforms being implemented and supported by this operation. In this context, the Government hopes IDA will approve the requested PRSC-ID to support recent and planned reforms in the financial sector which seek to promote the development of a sound, diverse, competitive, and inclusive financial sector.

Yours sincerely



Aiuba Cuereneia
Minister of Planning and Development and
Governor for Mozambique

C.c:

H.E. Manuel Chang
Minister of Finance

H.E. Ernesto Gove
Governor of Bank of Mozambique