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PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

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Operation Name	Mozambique - Financial Sector DPO II
Region	AFRICA
Country	Mozambique
Sector	Credit Reporting and Secured Transactions (5%); SME Finance (35%); Payments, settlements, and remittance systems (25%); Banking (25%); Capital markets (10%)
Operation ID	P151861
Lending Instrument	Development Policy Lending
Borrower(s)	GOVERNMENT OF MOZAMBIQUE
Implementing Agency	Ministry of Economy and Finance (MoEF) Banco de Moçambique (BdM)
Date PID Prepared	July 24, 2015
Estimated Date of Appraisal	August 6, 2015
Estimated Date of Board Approval	September 29, 2015
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Country and Sector Background

The Second Programmatic Financial Sector Development Policy Operation (FSDPO II) is the second in a series of three DPOs that seek to promote financial sector (FS) development. All the operations in the series are single tranche. The amount for FSDPO II is US$25 million. Its main objective is to reinforce financial stability, increase access to finance by households and firms, and enhance the development of long-term financial markets.

Mozambique's economy has grown rapidly since the end of the Civil War in 1992. Annual GDP growth averaged 7.4 percent over the past two decades. Robust growth was made possible by sound macroeconomic management, a number of large-scale foreign-investment projects ("megaprojects") and significant donor support. Mining, electricity and services led the expansion, and in recent years growth has increasingly been driven by massive foreign direct investment (FDI) inflows focused on the extractive industries. Major discoveries of coal and natural gas may transform Mozambique into a significant player in global fuels markets. But, to reap the benefits of a growing resource sector, the government will need to develop the capacity to manage the country's extractive industries and ensure that they contribute to sustainable, broad-based growth, poverty reduction, and shared prosperity.

Mozambique's rapid economic expansion over the past twenty years has had only a moderate impact on poverty reduction. In 2013 Mozambique's per capita income was US$593, less than one-third of the Sub-Saharan Africa (SSA) average. Economic growth in the 1990s was accompanied by a significant drop in poverty rates, but since the early 2000s the link

between growth and poverty reduction has weakened. Between 1997 and 2003 the poverty headcount rate fell from 68 to 56 percent (12 percentage points) yet between 2004 2003 and 2009 poverty fell by only four percentage points. The weakened relationship between growth and poverty reduction is due to the changing pattern of growth, which in the past decade was driven by capital-intensive, import-dependent sectors and megaprojects. This pattern of growth is also reflected in Mozambique's labor markets, which continue to be dominated by low skilled labor in the agricultural sector while the rest of the economy is unable to offer better-remunerated jobs for the 300,000 new workers entering the labor force every year.

Moreover, the returns to growth have been heavily concentrated in the country's southern regions and urban centers, while poverty remains pervasive in the north and rural areas nationwide. Most of the drop in the depth of poverty in the country seems to have happened in the Maputo province. For the rest of the country, individuals living in extreme poverty in 2009 appear to be as poor as those living in extreme poverty 12 years before. Between 2003 and 2009, while poverty rates dropped in most of Mozambique's provinces, they have increased in Zambezia, Sofala, Manica and Gaza. As a result, the number of poor people in these five provinces increased by 1.6 million (2.4% per annum). In 2009, these five provinces accounted for approximately 70 percent of the poor in the country, up from 59 percent in 2003. Zambezia and Nampula alone accounted for almost half of the poor (48 percent), up from 42 percent in 2003. Differences in returns to household attributes or endowments seem to explain most of the differences in the evolution of poverty rates between Nampula and Zambezia and the rest of the country. This is likely due to a combination of a relatively poor education quality, a lack of opportunities of income generation activities for educated people in these regions, and a limited access to financial services. This suggests that policies aimed at accelerating poverty reduction in Mozambique will need to aim at (i) better integrating these two provinces with the rest of the country's economy, and (ii) improving the quality of endowments/attributes of households in these provinces, especially the quality of education and access to financial services.

Key development challenges in Mozambique include the need to enhance inclusive growth and diversify the economy by boosting private sector productivity. Accelerating poverty reduction and promoting shared prosperity will require more inclusive growth in Mozambique. On the other hand, the economy remains fairly concentrated in terms of its export basket (focused on natural resources). This limited diversification signals the low productivity of other sectors in the economy. Mozambique's growth over the last two decades has presented a largely unrealized opportunity for the domestic private sector. Moreover, the current development of the country's non-renewable natural resources offer an opportunity, but constraints to maximizing those linkages are related to the competitiveness and productivity of local firms. Indeed, Mozambique's ranking in the 2014-2015 Global Competitiveness Report (GCR) is 133 out of 144, which reflects a restrictive business environment.

II. Operation Objectives

The development objective of the Proposed Financial Sector Development Policy Operation (FSDPO) Series is to reinforce financial stability, increase access to finance by households and firms, and enhance the development of long-term financial markets. The DPO is organized around three pillars: (I) Financial Stability; (ii) Financial Inclusion; (iii) and Long-Term Financial Markets.

III. Rationale for Bank Involvement

The Government recognizes the importance of Financial Sector (FS) development to reduce poverty and improve the business environment. Towards that end, a number of FS reforms have been initiated and the *Mozambique Financial Sector Development Strategy 2013-2022* (MFSDS) was adopted to provide a vision and a comprehensive and detailed roadmap for reforms in the FS.

The Government started efforts to tighten fiscal policy in 2015. Fiscal policy has been expansionary over the past few years, expanding from 32 percent of GDP in 2011 to an estimated 43 percent of GDP in 2014. This has been partly facilitated by rapid growth in tax revenues, which have grown from 17 percent of GDP in 2011 to over 24 percent in 2014, reflecting efforts to improve tax administration and capital gains taxes from the extractive industries. Without capital gains taxes, tax revenues have increased by 1 percentage point per year over the past few years. This increase in revenue compensated for a decline in aid flows, which in 2014 financed 12 percent of expenditures (down from 30 percent in 2009). The new government is committed to a prudent fiscal stance as suggested by the recently approved budget for 2015. In the 2015 budget, expenditure is forecast to decline by 6.4 percentage points of GDP and the deficit will narrow by almost 4 percentage points of GDP. Both current expenditures (particularly goods and services) as well as capital expenditures will decline. The wage bill will decline slightly, from 11.4 percent of GDP to 10.9 percent of GDP. Personnel costs are expected to slowly decline below 10 percent of GDP by 2018. This more prudent fiscal stance demonstrates the new government's reform orientation, which will be crucial as Mozambique continues to prepare for managing a much larger resource envelope when resource revenues start to flow.

Mozambique's medium-term macroeconomic outlook is positive. Annual growth is projected at 7 percent in 2015. The initial growth projection (of 7.5 percent) was revised downward by 0.5 percentage points as a result of the floods that affected the center and north of the country in early 2015. Growth will recover in 2016 and 2017 to around 8 percent as agriculture recovers from the 2015 floods and growth continues strong in the resource sector, construction, transportation and communications. In the short run, resource-related FDI, and infrastructure investments, both public and private, are expected to be major contributors to growth. While commodity prices are low, they are unlikely to decline further and are instead expected to gradually rise. LNG investments in Mozambique are expected to continue given the current market conditions. Unexpected declines in commodity prices may have an adverse impact Mozambique's economic prospects as it could affect the country's external balance and the timeline for investments in LNG plants in the north of the country.

The FSDPO series has incorporated lessons from FSDPOs in Africa, Europe and Central Asia, and Latin America as well as country-specific lessons, such as: ensuring cooperation at all levels of government; including TA and strong analytical underpinnings; considering the political economy and timing of reforms; and collaborating closely with donors to ensure a coordinated approach. Implementation capacity is limited in Mozambique and most FSDPO reforms fall under two institutions. Thus, the number of reforms supported by the FSDPO series has been kept at a manageable level (considering timing and sequencing issues) and complementary TA has been mobilized to support the implementation of reforms. The GoM has

demonstrated commitment to the implementation of FS reforms over the last decade (as evidenced by the implementation of FSAP recommendations) and FSDPO is closely aligned with MFSDS. Moreover, the DPO series is helping to prioritize key MFSDS reforms and boosting the reform momentum to complete the last step in the approval process of some reforms that had been in the making 2-3 years.

The IMF concluded its 4th PSI review in July 2015. Mozambique started a new PSI with the IMF in 2013. The 4th PSI review (See annex 3) acknowledged Mozambique's strong growth record. Program performance was assessed as mixed because of macroeconomic policy slippages, particularly on the management of international reserves, while progress in implementing structural reforms was adequate. Key structural reforms suggested by the review include improving VAT and overall tax management, continuing public financial management reforms, strengthening public investment management capacity and improving the business environment. The Bank and the IMF cooperate closely in supporting the GoM to promote financial development, including through the provision of complementary TA. FSDPO II is aligned with MFSDS, the approval of which was a structural benchmark in the previous PSI.

IV. Tentative financing

Source:		($m.)
BORROWER/RECIPIENT		0
International Development Association (IDA)		25
Borrower/Recipient		
IBRD		
Others (specifiy)		
	Total	25

V. Tranches *(if applicable)*

	($m.)
First Tranche	25
Total	25

VI. Institutional and Implementation Arrangements

The Ministry of Economy and Finance (MoEF) will be responsible for the overall oversight and implementation of the DPO. Within MoEF, the lead department will be the National Treasury. The *Banco de Moçambique* (BdM) is a key partner in implementation as many of the actions under the inclusion and stability pillars fall under its purview. The *Bolsa de Valores de Moçambique* (BVM) will be the main technical agency for the actions related to capital markets while the *Instituto de Supervisão de Seguros de Moçambique* (ISSM) will be the main technical agency for actions relating to insurance and pensions. MoEF and BdM, as the lead implementing agencies, have extensive experience and are fully versant with Bank policies and procedures through investment lending and policy based operations.

A results framework has been developed for the Operation. The results framework is consistent with the goals set out in the MFSDS and the broader Five Year Government Plan. The monitoring of FSDPO II will benefit from the Government's monitoring and evaluation mechanisms for the implementation of the MFSDS. The achievement of targets will be assessed based on market players and household surveys and will draw on the regular supervision function of the BdM, national level data, and specialized surveys on access to be conducted. The World Bank will play a supporting and monitoring role, reviewing progress and making needed adjustments. The FSDPO II team will monitor overall progress achieved towards the expected outcomes of the DPO series. The review will be based largely on the monitoring indicators and the goals of the program.

VII. Risks and Risk Mitigation

The overall risk rating for FSDPO II is moderate. The three main risks to this operation are related to implementation capacity, macroeconomic management, and sustainability of commitment to reform given the change in administration.

FSDPO II has an implementation capacity risk given the range and relevance of reforms covered and the concentration of these reforms in two implementing agencies. Implementation capacity risk is moderate. The concentration of efforts helps to streamline and focus the dialogue and the two lead agencies possess relatively well trained staff and advanced systems. However, there are several measures to be implemented by the MoEF and BdM and some require numerous technical decisions. To ameliorate the implementation capacity risk the team is: (i) maintaining an ongoing dialogue with the authorities on the reform package; (ii) providing targeted TA on supported reforms and coordinating further TA to be provided by Bank/IFC experts and other donors; and (iii) considering the political economy of reform while following a pragmatic approach, understanding that some complex financial sector reforms take more time to materialize.

The second risk is the maintenance of a stable macroeconomic environment due to: an expansionary fiscal policy, rising public debt, rapid increases of CA deficits and downside risks. Macroeconomic risks are moderate. Fiscal policy has become expansionary, with increased spending (related with personnel costs for priority sectors and the elections as well as infrastructure projects and EMATUM) and a higher budget deficit. There is also rising public debt (to finance infrastructure investments), with a rising share of non-concessional loans in new external debt. The authorities have committed to tighten fiscal policy though (and this is reflected in the approved 2015 budget). As savings remain relatively low and large investments are being made by the public and private sectors, the CA deficit is worsening. The deficit does not indicate a fundamental imbalance in the economy though as it reflects the impact of rapid import growth associated to large FDI inflows. The Mozambican economy also faces significant downside risks such as declines of commodity prices and the country's security situation, which could affect the development of coal and gas sectors. Government capacity needs to be strengthened: (i) in the medium term given the expected increase in government revenues from natural resources; and (ii) in the short term to manage government debt and public investment related with infrastructure investments. Prior actions included in this DPO (Pillar III), the PRSC series and the IMF PSI will ameliorate risks related with this lack of government capacity. The GoM has a stable working relationship with the IMF anchored by a PSI, which has contributed to ensuring sound macroeconomic management.

There are political risks associated with the change in administration. Political risks are substantial. Following the October 2014, elections, Mozambique has a new president since January 2015 who comes from the ruling party Frelimo. Frelimo also secured a strong majority in the parliament (144 seats out of 250 in total), though in sharp decline compared to the previous election in 2009 when it garnered 75 percent of the vote. Renamo, the largest opposition and former rebel group, more than doubled its seats (89 seats), and MDM, a third political party with parliament representation, obtained 17 seats, also doubling its presence. A new Government was named in January 2015 streamlining several Ministries with a key change being the merger of the former Ministry of Planning and Development MPD and the Ministry of Finance into a new Ministry of Economy and Finance. Political risks for the FSDPO series are mitigated by the highly participatory process through which the new MFSDS was developed, which strengthened the ownership of the strategy by stakeholders in government, the private sector and financial institutions. The continuation of FS reforms in prior election cycles and stability of the technical staff in the relevant implementing agencies are also mitigating factors of political risk. To mitigate these risks, the DPO series focused on prior actions that were advanced and supports the Government on the implementation of reforms covered by the DPO series through related TA. The likelihood of major policy reversals with this new Government is therefore limited; indeed the new Government has largely continued the reform program adopting several reforms both in the financial sector and in other key areas since it was installed.

VIII. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

The proposed operation is expected to have positive social and poverty impacts by promoting FS development. Evidence strongly indicates that, when effectively regulated and supervised, financial development spurs economic growth, reduces income inequality and helps to lift households out of poverty (World Bank 2008). Well-developed financial systems have a strong positive impact on economic growth over long-term periods (Levine 2005; Demirguc-Kunt and Levine 2008). FS development is also pro-poor and is associated with significant declines of extreme poverty (Beck, Demirguc-Kunt and Levine 2004 and 2007). While not conclusive, empirical evidence suggests that there is a strong beneficial effect of financial development on the poor and that poor households and smaller firms benefit more from financial development. For households, financial development facilitates consumption smoothing and human capital investment. For firms, increased access to finance is associated with higher returns and better performance. Similarly, theory indicates that financial development facilitates entrepreneurship by people with promising ideas but little collateral and income and provides access to risk management among others (Demirguc-Kunt and Levine 2009). FS development reduces income inequality by disproportionately boosting the income of the poor and evidence suggests that the indirect effects of finance on inequality are substantial (Demirguc-Kunt and Levine 2004 and 2009).

FSDPO II Pillar I will contribute to a stable financial system, thereby benefiting the poor to a greater extent. Financial crisis harm the poor disproportionately, affecting poverty and income distribution through a variety of channels (Baldacci, de Mello and Inchauste 2002). Financial crisis typically lead to a slowdown in economic activity and, consequently, rises in unemployment and/or falls in real wages. If there is also fiscal retrenchment, this often leads to cuts in public outlays on social programs and transfers to households among others. Thus, financial crisis are associated with deterioration in poverty indicators. Specifically, the DGF

supported by the FSDPO series is expected to minimize the fiscal costs associated with the resolution of financial institutions and protect the savings of smaller depositors. Pillar I also includes stronger AML/CFT safeguards for the financial system which are essential for system's integrity and stability. However, one inadvertent impact of stricter AML/CFT requirements is limiting access to low income clients as banks impose additional documentation and Know-Your-Customer (KYC) requirements. This adverse impact can be mitigated by banks applying more of a risk-based approach to KYC requirements so that low income clients are not negatively impacted.

Under Pillar II, better financial inclusion will benefit the poor. Modern development theory sees the lack of access to finance as a critical mechanism for generating persistent income inequality and slower growth (Demirguc-Kunt and Levine 2008). Small enterprises and poor households face much greater obstacles in their ability to access finance all around the world but more so in developing countries like Mozambique. Reforms under FSDPO II Pillar II will benefit lower income individuals, smaller enterprises and rural areas in particular. First, credit bureaus should contribute to increased access and affordability of financial services (Demirguc-Kunt and Levine 2008). Better credit information is particularly beneficial for individuals and enterprises with little or no collateral. This is the case of low income individuals and micro & small enterprises. Low income individuals, in particular in the rural areas, cannot by law use their main asset, i.e., land, as collateral. Further, these individuals often own small household firms where they sell their agricultural produce. But without a proper credit information system, they are unable to access the financial system in order to start, operate, and expand their businesses. As a result, such household enterprises often operate on a low productivity basis, with implications for the poor. Second, in most cases, the difficult access to the banking system by the poor occurs because banks work where they have economies of scale. In other words, the spread of formal banking services rises with income. And as discussed above, incomes are lower in the rural areas, in particular in the central and Northern provinces of Mozambique. Reforms to expand agency banking and e-money will have a positive impact on vulnerable groups by expanding financial services in these areas and by reducing transactions costs (e.g. traveling costs) through electronic systems. This allows accounts to be maintained at relatively low costs to savers and borrowers located in these underserved areas. Third, reforms on consumer protection and financial information will be particularly helpful for less sophisticated consumers. Lack of knowledge about the type of charges implemented by the banks often push away uneducated and low income individuals from the financial system. They would rather opt for less secure and more expensive ways of saving their incomes and of accessing funds. Anecdotal evidence mentions burying money and/or placing it under the mattress as some of the ways the poor save. As for accessing funds, they often resort to expensive informal micro money lenders. Thus, with improved transparency on terms and conditions of charges on financial products and services, low income individuals will have a greater incentive to approach the financial system.

FSDPO II will promote women's access to finance. For example, promoting innovations and improvements in financial products and delivery models (such as e-money and agency banking) would benefit women in particular since they have more time and mobility constraints than men. Addressing constraints on the demand side begins with reinforcing the ability of women to act as informed and capable financial consumers. Therefore, reforms to strengthen financial consumer protection would also benefit women, who are more vulnerable than men and have lower financial knowledge and skills. Finally, reforms to increase the efficiency of collateral (such as credit bureaus and collateral registries) which allows women to establish a credit history and use a broader set of assets would improve their access and usage of financial services.

FSDPO II Pillar III will contribute to the diversification of funding sources. This diversification is expected to stimulate private investment, economic growth, and poverty reduction. Actions to strengthen government debt markets are critical for reducing costs and increasing efficiency in the banking sector. For instance, regular supply of government bonds will improve predictability and transparency in the FS; auctions of government securities and their announcement will improve efficient pricing of financial instruments. Additionally, FSDPO III will promote the strengthening of the insurance and pensions sectors. While insurance reduce individuals and enterprises vulnerability to shocks, pensions provide protection against the risk of poverty in old age and can provide an important source of domestic long-term capital for investment.

Environment Aspects

This operation is not expected to have any negative environmental impacts given the policy areas and reforms covered. FSDPO II prior actions seek to enhance financial stability (Pillar I), promote financial inclusion (Pillar II), and develop long-term financial markets (Pillar III). Reforms to promote financial inclusion can increase access to credit, particularly for smaller firms. This could generate the creation/growth of localized and easy to implement businesses (small scale income generating activities, such as flower growing, horticulture, agriculture, etc.). Although some minimal downstream impacts may occur as result of the small income activities, these efforts will be easily dealt with and accompanied by the Government, particularly the Ministry of Agriculture and Food Security (MINASA) and the Ministry for Land, Environment and Rural Development (*Ministério para a Terra, Ambiente e Desenvolvimento Rural* - MITADER) which is the leading agency responsible for the implementation of the Environment Law and coordinates all aspects related to environmental management. These entities are currently implementing Bank funded projects which have existing well trained Environmental & Social Safeguard Specialists. Furthermore, MITADER and MINASA have acquired considerable experience with World Bank projects and are so familiar with implementation and supervision procedures including with set of environmental and social national regulations. Both entities are staffed with sufficient technical capacity to accompany such micro-projects likely to be funded by financing services.

IX. Contact point

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