Subject: Letter of Development Policy for the First Programmatic Financial Sector Development Policy Operation (FSDPO I)

Dear Mr. Lundell,

I. I am writing on behalf of the Government of the Republic of Mozambique to request the FSDPO I in the amount of US$ 25 million from the International Development Association (IDA), to support the implementation of the Mozambique Financial Sector Development Strategy (MFSDS) 2013-2022, which was adopted by the Council of Ministers in April 2013. The aforementioned Credit will help meet the financing requirements that Mozambique faces to implement the MFSDS during the annual budget for the year 2014.

2. We would like to commend your commitment to the Government’s financial sector development program, which seeks to encourage a “strong, healthy, inclusive, competitive, transparent and resilient financial system that promotes economic development”.

3. The objective of the FSDPO is to reinforce financial stability, increase access to finance by households and firms, and enhance the development of long-term financial markets. This will contribute directly to the strategic objectives of the MFSDS of maintaining financial sector stability, improving financial inclusion, and increasing the supply of private capital to support development. Moreover, the FSDPO I will also support the “Plano de Acção para Redução da Pobreza” (Action Plan for Poverty Reduction - PARP 2010-2014) and the Programa Quinquenal do Governo (Five Year Government Plan - PGG 2011-2015), which emphasize the importance of private sector led growth and the need for the private sector to have access

To:
Mr. Mark Lundell
Country Director
For Mozambique, Comoros, Madagascar, Mauritius, and Seychelles
World Bank
to finance to create jobs.

4. FSPO I 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, despite a still-fragile world economic environment resulting from the financial crisis that shook the international economy and was exacerbated by the Euro zone sovereign debt crisis:

- In 2013 economic activity grew by 7.0 percent, lower than the growth forecast due to the negative impact of floods in early 2013. Growth has been strong, supported by the expansion and rapid rise in coal production as well as in financial services, transport and communications, and agriculture, the last making a major contribution to GDP. We expect the economy to grow by 8 percent this year.

- The year-end inflation rate remained relatively low at 3 percent, well below the target of the Central Bank. Inflation is expected to remain between 5.5-6 this year, supported by a relatively weak South African Rand and strong agricultural production. Mozambican authorities remain committed to maintaining a low inflation environment.

6. BOP developments in 2013 were dominated by operations related to the development of the LNG sector. Current accounts deficit have widened and stand now around 40 percent of GDP, as a result of large capital imports related to investments in the minerals and petroleum sectors. FDI continues strong and finances the large current account deficit. Grant financing has fallen over the past few years and now stands at slightly below 4%, from 8% in 2011. Traditional exports continued their strong performance and grew by almost 74 percent between 2011 and 2013 (in US$ current terms).

7. Due to these BOP developments, the country had a stock of reserves of $3.2 billion at end-December 2013, equivalent to approximately 4.8 months of projected imports of non-megaproject imports for 2013 compared to 5.8 months at the end of 2011. Toward the end of the decade the current account deficit will close with the end of the construction phase of the coal and gas developments and the pick-up of exports - which should lead to a significant increase in reserves.
8. In 2014 public spending will reach 42.2 percent of GDP. This relatively large spending is a result of a number of one-off expenditures such as the post-floods reconstruction, the 2014 general elections as well as large investments in defense equipment. In the medium term, we expect public spending to decline to 40 percent by 2016. Revenues have increased rapidly over the past few years, partly as a result of capital gains taxes related to petroleum operations in the Rovuma basin. We expect tax revenues to continue increasing steadily over the next two years, and Mozambique will finance large infrastructure investment through external credits. As a result, public debt has increased and reached 45 percent of GDP in 2013, from around 40 percent in 2008. The rise has been led by rapid growth in external debt. A large share of this debt has been contracted in non-concessional terms, particularly in the past few years. While in 2010 non-concessional loans accounted for only 9 percent of all new external debt, in 2012 this was over 70 percent. A large share of the new debt is financing a significant increase in infrastructure spending aimed at closing Mozambique's infrastructure gap and the Government will continue with reforms to strengthen our ability to manage this increased debt burden.

9. We expect growth in the medium term to remain high and robust, reflecting rapid growth in the extractive industry and hydrocarbon sector. However, the still-fragile world economic environment will constitute a risk to growth in the short term.

- Over the next five years, the increased contribution of coal production and exports; the implementation of significant infrastructure projects, including the liquefied natural gas plant; greater dynamism in the construction and transport and communications sectors, and continuing growth in other sectors could accelerate economic growth to rates between 7% and 8 percent per year, in line with our objectives.

- We maintain our medium-term inflation objective of 5 to 8 percent per year.

- Developments in the external sector over the coming years will continue to be influenced by the emergence and development of new companies involved in direct foreign investment in mineral exploration. Thus, the current account deficit excluding grants could be around 45 percent of GDP, basically reflecting the increase in imports of goods and services to supply the large investments made by such enterprises, funded largely by FDI and private borrowing.

10. We will continue with our current combination of fiscal and monetary policies with a view to maintaining macroeconomic stability in the medium-term and promoting structural reforms. We will also strengthen
our macroeconomic planning tools and economic policy coordination within the government and with the Bank of Mozambique (BdM).

- Monetary policy will remain oriented toward achieving the objectives of keeping inflation low and stable, safeguarding the financial system, and encouraging lending to the economy. We will continue reforms to improve operations of the banking system and broaden further access to financial services for depositors as well as borrowers.

- Fiscal policy will continue to meet the objectives in terms of natural resource taxation, priority spending on infrastructure investment, health and education, and income redistribution. Public spending as a share of GDP will decline in the medium term below current levels. The medium-term fiscal framework (CFMP) for 2014-16 envisages moderate fiscal deficits, continued strong external support, and modest domestic financing needs. It demonstrates the Government's efforts to increase internal revenue generation capacity and cover the outlays necessary to keep its administrative machinery running with self-generated funds.

**Implementation of the Poverty Reduction Strategy**

11. *We are committed to sustain our pursuit of more inclusive growth during and beyond the current Poverty Reduction Strategy (PARP 2011-14).* 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 launched an agricultural investment plan (PNISA) 2013-17 that will help to gradually shift production from subsistence to commercial farming in 2012. There was progress in land use titles, productivity and monitoring systems.
13. **Creating employment.** In 2012, 270,287 formal sector jobs were created: 92,140 in the public sector and 178,127 in the private sector, of which more than half were for Mozambican miners to work in South Africa in line with bilateral agreements. While this figure exceeded the goal by 6 percent, it was 14 percent lower than in 2011 reflecting mainly the contraction in the South African mining sector affected by domestic events and the global financial crisis. The establishment of the Labor Market Monitoring Group, a forum of stakeholders on labor market issues, will deepen interactions on the linkages between the demand and supply of jobs, and help improve employment policies and statistics. Improvement of the business climate will be crucial to attract more investors and enhance employment creation. We have been working in partnership with the IFC and World Bank since 2010 to assess and streamline business licensing requirements and procedures, and this work will continue.

14. **Enhancing social and human development.** Efforts to boost primary school enrolment continued. The school enrollment rate at age 6 in first grade increased by two percentage points relative to 2011, and net enrollment at age 7 is close to 100 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. Also notable is the significant increase in age-appropriate enrollment at different levels. 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 (Public Financial Management) systems in the sector have also strengthened with bi-monthly monitoring of the sector accounts.

**Investment Planning and Debt Management**

15. **The Government will continue to give priority to modernizing its debt management and investment planning procedures:**

- Strengthening investment planning. The Ministry of Planning and Development (MPD) is revising the Integrated Investment Program (IIP) which was submitted for Cabinet approval in September 2013. The document will present a list of priority projects together with sufficiently specific information to analyze the impact of related borrowing on debt sustainability.
• Strengthening project selection tools. In February 2013, the MPD completed the Project Preparation Manual and template along with a form for a summary description of individual projects. The Project Management and Selection Committee will start using the Manual to analyze projects and, once Cabinet approved a particular project, will publish the template and summary description on the website with relevant information on that project. A key aspect of this reform is the need to build capacity in both central economic and line ministries in the use of the new project selection tools and criteria.

• Enhancing debt management. The preparation of a Debt Sustainability Analysis has been finalized and will serve as an input for the 2014 State Budget. The Government intends to incorporate the analysis of costs and risks associated with the public debt portfolio and borrowing plans over the medium term in the quarterly debt report, ensuring linkages with the State Budget and the Integrated Investment Program, as well as enhancing debt monitoring in line with the medium-term debt strategy (MTDS).

• Advancing development of capital markets and first Annual Domestic Borrowing Plan for 2013. In order to promote public savings and stimulate domestic capital market development, a domestic borrowing plan will be prepared annually after the budget has been approved. The first such plan was approved and published in January 2013. Consistent with World Bank/IMF technical assistance recommendations for an auction strategy and determination of a yield curve for the state, as of 2013, Treasury bonds (T bonds) will be issued in several tranches per year and interest rates will be determined at auctions held at the stock exchange. Decree 5/2013 of March 2013 paved the way for the introduction of specialized Treasury bond dealers (DEOT). About ³ of the total of 20 financial institutions invited to become DEOTs have accepted, facilitating the creation of a secondary market. The first primary T bond auction took place in April 2013 and was substantially oversubscribed.

Financial sector reforms and the MFSDS

 Evolution of the financial sector

16. Over the past two decades, Mozambique has successfully implemented major financial sector reforms that substantially improved the sector's performance. In the decade to 2003, the Mozambican financial system moved from being entirely state-owned to a market based system dominated by banks that represented about 95 percent of total financial system assets. Prior to 2003 the overall quality of
financial intermediation was severely limited by substantial amounts of nonperforming loans (NPLs) in
the banking system, high and volatile real lending rates driven by high NPL levels and a lack of
competition in the system, as well as a generally poor lending environment. High and volatile metical
interest rates also threatened the stability and development of the financial sector by promoting
dollarization and raising the cost of domestic public debt.

17. To address the problems of the banking sector, important reforms were undertaken by the Government
between 2005 and 2007. The Government, in collaboration with donors and civil society, developed and
implemented a comprehensive financial sector reform strategy supported by the Financial Sector
Technical Assistance Project (FSTAP). Notable financial sector reforms included: revisions and/or
adoption of new laws and regulations for the regulatory framework of the financial sector; (ii) the
establishment of new institutional mechanisms for banking supervision and the resolution of commercial
litigation; (iii) the introduction of International Financial Reporting Standards (IFRS); (iv) the
establishment of the Financial Information Center of Mozambique (GIFIM); (v) introduction of the
electronic funds transfer subsystem; (vi) enhanced transparency; and (vii) use of market instruments in
the implementation of monetary and exchange rate policy.

18. As a result of these efforts, (i) total assets in the financial system increased; (ii) State intervention in the
banking sector decreased; and (iii) NPLs for the system as a whole declined dramatically (from 21
percent of total loans at end-2002 to 2.1 at end-2008).

Recent and planned reforms in the financial sector

19. The BDM will continue reforms aimed at enhancing financial sector surveillance despite the difficult
global environment. It remains focused on:

- Strengthening banking supervision with a view to mitigating and preventing systemic risk. A sample
  of lending institutions’ data was collected for conducting the first stress tests, with the expectation
  that this exercise will be performed by a designated team as part of the quarterly surveillance
  process from July 2013 on, including with the respective report on stress tests results. In this
  context, the regulation pertaining to NPL accounting was revised in August 2013 to make it
  internationally comparable. Likewise with a view to strengthening surveillance, the risk management
guidelines and the legal and analytical framework for risk-based surveillance were adopted on March
14, 2013 on track for the adoption of Basel II Capital Accord in 2014.
- Completion of the financial sector contingency plan. The package of rules governing the Contingency Plan and Emergency Liquidity Assistance was completed and approved in early April 2013. The underlying legal provisions were published in April 2013. Implementation will start in June, including the preparatory work to conduct simulation exercises with the help of the World Bank.

- Making the Deposit Guarantee Fund (DGF) operational. The members of the DGF’s Executive Board were appointed in May and June 2013. The capitalization of the fund will occur after related decisions (e.g. on deposit coverage, banks’ contribution and investment criteria) are made and incorporated into a Ministry “Aviso”. The Ministry of Finance will capitalize the Fund with initial Government contribution as set out in the DGF decree.

20. We will step up our efforts to improve financial inclusion as part of Mozambique’s Financial Sector Development Strategy (FSDS) for 2013-2022. Key priorities include:

- Establishing private credit bureaus. A law allowing the creation of private credit bureaus was approved by the Council of Ministers in December 2013 and has been submitted for Parliament’s consideration.

- Promoting mobile financial services. Specific regulations governing mobile financial services are under preparation by a task force at the BDM. Given the dynamic nature of these particular services, two operators have already been licensed.

- Encouraging banking competition. We will foster competition in the banking sector by (i) introducing laws and regulations that address anti-competitive practices, (ii) fostering transparent pricing for financial services to allow consumers to compare costs, and (iii) introducing low-cost online access to credit files. A consumer protection framework will be designed and outreach will promote financial awareness so as to allow consumers (including SMEs) to make better use of available financial services; to encourage competition and innovation amongst financial services providers; and to provide consumers with reasonable protections against unfair business practices, while ensuring financial institutions’ soundness.

- Strengthening the insolvency framework. An Insolvency Bill was passed by the Council of Ministers in July 2013 based on the legislative authorization issued by Parliament in March 2013.
• Collateral framework. We will work on a Collateral Bill with an eye to establishing a moveable collateral registry.

21. The AML/CFT framework continues to be improved. A draft AML/CFT law was approved by Parliament on May 16, 2013. Under the new law the financing of terrorism is considered a crime. The government is also pursuing a plan for implementing the FATF standards approved by the FATF-style regional body (ESAAAMLG). It will build on the recommendations of an IMF Legal Department mission of April 2013 and the technical assistance action plan for eliminating shortcomings identified in the legal system; supervision of financial institutions and Designated Non-Financial Business Professions (DNFBP), Legal Persons and Arrangements; and international cooperation matters.

22. The BDM will further enhance financial stability and promote market development through reforms in the national payment system. In pursuing this objective, the BDM will continue to focus mainly on oversight practices and development of the retail payment systems:

• Enhancing oversight practices. The BdM approved a payment systems oversight policy strategy in March 2012 and will finalize and implement an oversight function in 2014. Key actions would include (i) the implementation of an oversight manual, and (ii) the start of the operations of an oversight unit.

The MFSDS and FSDPO

23. In recent years the Government, development partners, and academics have completed analytical work designed to identify further reforms which could strengthen, broaden, and deepen the financial sector.

The objective of the MFSDS is to consolidate stakeholders' recommendations across the financial sector into a single document, which: provides the Government's policy framework and strategy for the development of the financial sector over the next decade; elaborates specific activities which will support the achievement of the MFSDS' goal; and, puts in place the institutional mechanisms required to coordinate and control its implementation.

---

1 The MFSDS draws on: (i) FIRST Initiative-sponsored field work in 2011 to consult with stakeholders, update, refine, and elaborate earlier drafts of the strategy; (ii) the Financial Sector Assessment Program (FSAP) completed by the World Bank and International Monetary Fund (IMF) in 2009; (iii) National Campaign for Rural Savings (2005); (iv) Programa de Apoio às Finanças Rurais (2005); (v) Rural Bancarization Strategy (2007); (vi) Rural Development Strategy (2007); (vii) World Bank Country Economic Memorandum (2009); (viii) Investment Climate Assessment (2009); (ix) FinScope™ (2009); (x) the Rural Finance Strategy (2011), (xi) the Government's Medium Term Debt Management Strategy (2012), and (xii) the Banco de Moçambique's Strategic Plan.
24. The MFSDS has been developed in order to tackle the major challenges to the development of the financial sector. These challenges can be subdivided into two groups, namely:

- Economy-wide structural impediments to financial intermediation that limit the number of creditworthy clients. Poor physical infrastructure, obstacles to the use of technology, weaknesses in the legal and regulatory framework, weak financial reporting by non-bank financial institutions and problems in using credit information infrastructure and framework for credit enforcement are but a few of these impediments.

- Limited competition in the banking sector and high transaction costs that reduce incentives to intermediate deposits into loans while also contributing to higher borrowing costs.

25. The goal of the MFSDS is to promote the development of a sound, diverse, competitive, and inclusive financial sector which provides citizens and businesses – particularly SMEs – with convenient access to a range of appropriate, high quality, financial services at affordable prices. The policies and actions that will implement the MFSDS are organized into three groups of strategic objectives: (i) maintain financial sector stability; (ii) improve financial access and support the growth of financial inclusion; and, (iii) increase the supply of private capital to support development.

26. In order to reach the objectives of the MFSDS, the implementation of its policies and strategic actions will be guided by four principles: (i) maintenance of macroeconomic and financial stability; (ii) fostering competition in the financial system; (iii) encouragement of innovation; and (iv) improving access to finance and inclusive growth.

27. FSDPO I is aligned with the strategic objectives of the MFSDS (i.e. increased financial sector stability, financial access and private capital), its focus areas (such as bank regulation and supervision, financial sector safety nets and infrastructure, and domestic bond markets), and its goals. The latter include: the strengthening of loan classification and provisioning requirements, risk management, AML monitoring and enforcement; the adoption of prompt corrective actions; the establishment of a deposit insurance system; the expansion of credit information; and improving the framework for creditor rights, e-banking and mobile financial services.

28. Reforms to be supported by the FSDPO I are:
• The BdM issues a new loan classification regulation that revises the definition and recording of non-performing loans (NPLs) bringing it more in line with international best practices.

• The BdM issues risk management guidelines for banks fostering better risk management practices in line with international best practices.

• BdM developed and approved regulations pertaining to emergency liquidity assistance (ELA) for banks enabling the BoM to act as lender of last resort.

• The MoF and BdM conclude the nominated members to the Management Committee of the Deposit Guarantee Fund (DGF).

• New AML/CFT Law has been approved by Parliament.

• The Council of Ministers has passed Insolvency Bill.

• The BdM strengthened oversight function by separating the oversight and operational functions of payment systems.

• The Ministry of Finance conducted five competitive bond (OT) auctions following the published 2013 annual borrowing plan and in line with the recent primary dealership legislation (Decree of March 2013 and Diploma of April 2013) and publicly announces the auction results on the Bolsa de Valores de Mocambique (BVM) website and in the Stock Exchange Bulletin Board.

• The Ministry of Finance has passed the diploma on the operational norms of the Central Securities Depository for the BVM.

• BdM issued a comprehensive set of norms to update money market regulation, including the following Avisos (all from June 06, 2013): (i) Aviso No. 5 on the Market Operations System (SOM), comprising procedures and norms for interbank money and FX markets; (ii) Aviso No. 6 on norms for Repos/Reverse repos in the interbank money market; (iv) Aviso No. 7 updating norms and procedures for money market operations between banks and between BdM and banks; and (iv) Aviso No. 8, on primary and secondary markets of BTs.
Conclusion

29. To conclude, we would like to highlight the Government's commitment towards maintaining macroeconomic stability and promoting financial sector development through the implementation of the MFSDS. In this context, the Government hopes IDA will approve the requested FSDPO I 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.

M. 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
Maputo