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**REPORT AND RECOMMENDATION
OF THE
PRESIDENT OF THE
INTERNATIONAL DEVELOPMENT ASSOCIATION
TO THE
EXECUTIVE DIRECTORS
ON ASSISTANCE TO
THE REPUBLIC OF MOZAMBIQUE
UNDER THE HIPC DEBT INITIATIVE**

March 31, 1998

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CURRENCY EQUIVALENTS

Currency Unit = Metical (MT)

EXCHANGE RATE

US\$1.00 = 11,605 MT (March 30, 1998)

WEIGHTS AND MEASURES

Metric System

ABBREVIATIONS AND ACRONYMS

CAS	Country Assistance Strategy
CFM	<i>Caminhos de Ferro de Moçambique</i> (state ports and railways)
DSA	Debt Sustainability Analysis
ESW	Economic and Sector Work
GDP	Gross Domestic Product
HIPC	Heavily Indebted Poor Countries
IDA	International Development Association
IMF	International Monetary Fund
NPV	Net Present Value
PETROMOC	<i>Empresa Nacional Petróleos de Moçambique</i> (state oil company)
PFP	Policy Framework Paper
VAT	Value Added Tax

FISCAL YEAR

January 1 to December 31

Vice President	: Callisto Madavo
Director	: Phyllis Pomerantz
Manager, HIPC Unit	: Axel Van Trotsenburg
Staff Members	: Rocio Castro/Marc Stephens

**ASSISTANCE TO THE REPUBLIC OF MOZAMBIQUE UNDER
THE HEAVILY INDEBTED POOR COUNTRIES DEBT INITIATIVE**

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**MEMORANDUM AND RECOMMENDATION OF THE PRESIDENT
OF THE INTERNATIONAL DEVELOPMENT ASSOCIATION
TO THE EXECUTIVE DIRECTORS ON ASSISTANCE TO THE REPUBLIC OF
MOZAMBIQUE UNDER THE HIPC DEBT INITIATIVE**

1. I submit for your approval the following Memorandum and Recommendation on the assistance to be provided to Mozambique under the Heavily Indebted Poor Countries (HIPC) Debt Initiative in respect of debt owed by it to the International Development Association (IDA). This Memorandum and Recommendation addresses: (i) the assistance to be provided by IDA during the interim period; (ii) the relief that is proposed to be provided in respect of debt owed to IDA at the completion point; and (iii) the structural and social development performance criteria that Mozambique would need to have satisfied at the completion point in order for the assistance under the HIPC Debt Initiative to be provided at that time.

2. This document is accompanied by a paper entitled "Mozambique: Final Document on the Initiative for Heavily Indebted Poor Countries (HIPC)". The final HIPC Document reports on consultations with creditors regarding their envisaged debt relief and provides an update of the debt sustainability analysis jointly prepared by the Mozambican authorities and Bank and Fund staff. It also contains recommendations on: (i) Mozambique's eligibility for assistance under the HIPC Debt Initiative; (ii) the timing of the decision point and the completion point; (iii) the target for the net present value (NPV) of debt-to-export ratio at the completion point; (iv) the proposed actions by multilateral creditors to achieve the targeted NPV of debt-to-exports ratio at the completion point; and (v) the key performance criteria for Mozambique under the Initiative at the completion point. It should be noted that the Final HIPC Document builds on the Preliminary HIPC Document (IDA/SecM97-407, 8/20/97) and should be read in conjunction with that document.

PROPOSED DEBT RELIEF

3. As set forth in the Final HIPC Document, to bring Mozambique's NPV of debt-to-exports ratio to a target of 200 percent by the proposed completion date of June 1999, the multilateral creditors' proportional share of debt relief for Mozambique would amount to US\$526 million in NPV terms, or 62.9 percent of multilateral debt at the decision point, of which US\$295 million would be provided on debt owed to IDA. Based on proportional burden sharing, the bilaterals' share of relief would amount to US\$916 million in NPV terms. As described in the Final HIPC Document, bilateral commitments fall short of this required relief by approximately US\$116 million. This gap is expected to be filled through voluntary contributions; a Financing Plan will be distributed to Executive Directors prior to the Board discussion of the Final HIPC Document. It is proposed that the Executive Directors approve in principle, subject to confirmation by other multilateral creditors that they will provide proportional relief on their claims, the following:

- (a) the provision of relief in an amount having a net present value of US\$295 million in respect of debt owed by Mozambique to IDA; and
- (b) on a voluntary basis, an exceptional, additional contribution of about US\$29 million in NPV terms, to be provided in the context of an overall effort by other multilateral and bilateral creditors, as further detailed in the forthcoming Financing Plan, to fill the above mentioned shortfall of US\$116 million.

Relief on debt owed to IDA would be provided through actions during the interim period and at the completion point, while the additional relief would be provided through actions during the interim period.

Interim Measures

4. During the Board discussion of the Preliminary Document in September 1997, Executive Directors supported the use of interim measures during the period between the decision and the completion points to ease the debt burden. Management is proposing that Mozambique receive up to 75 percent of its IDA program funding in the form of grants during the interim period, since the projected NPV debt-to-exports ratio at the proposed completion point of June 1999 would be above 350 percent. These grants would amount to US\$183 million (or US\$61 million relief in NPV terms).

5. Management is also proposing to provide the exceptional debt relief referred to in paragraph 3(b) through measures during the interim period. These measures would include providing the remaining portion of the IDA lending program during the interim period in the form of grants. As a result, it is expected that 100 percent of the IDA program between the decision and completion points (lending of about US\$270 million consistent with the base case of US\$480 million envisaged in the most recent Country Assistance Strategy) could be provided as grants and that IDA's voluntary contribution would be delivered as shown in Table 1.

**Table 1. Indicative IDA Grant Funding in the Interim Period
(millions of US\$, unless otherwise specified)**

	In NPV terms	In Nominal Terms
Relief under Proportional Burden Sharing 1/	61	183
Additional Relief 2/	29	87
Total Base Case Program	90	270

1/ IDA's contribution under the HIPC framework, under which up to 75 percent of the lending program in the interim period could be delivered in grants (see "World Bank Participation in the Heavily Indebted Poor Countries' Debt Initiative," SecM96-926, August 26, 1996).

2/ Corresponding to the additional contribution discussed in paragraph 3(b).

In addition IDA, together with other possible donors, could help finance a second commercial debt buy-back, through a grant from the IDA Debt Reduction Facility, to reduce debts not covered under the 1991 operation.¹ Any relief from this would be over and above IDA's voluntary, additional contribution.

6. Approval by the Executive Directors of the provision of IDA grants for a specific project will be sought at the time the Executive Directors are requested to approve IDA funding for the project. The NPV reduction resulting from such grants (compared with the credits they replace) would provide debt relief to Mozambique equivalent to US\$90 million (in NPV terms). If the level of IDA funding during the interim period falls short of the amount envisaged under the base case scenario, Management recommends that the remainder of the assistance be provided through the further purchase of debt owed to IDA through the HIPC Trust Fund.

Completion Point Measures

7. The HIPC Trust Fund will set aside at the decision point the necessary resources, after taking into account the debt relief provided during the interim period, to provide the required relief on debt owed to IDA at the completion point. This will be equivalent to about US\$234 million in NPV terms. With these resources, the Trust Fund is expected, at the completion point, to purchase IDA credits with a nominal value to be determined on the basis of the principles agreed upon for calculating the NPV of debt in DSAs and by selecting for purchase the oldest IDA credits.² These IDA credits, amounting to approximately US\$512 million in nominal terms, will be purchased by the HIPC Trust Fund and then canceled, and the Mozambican authorities will be informed that the debt is no longer due.

¹ See "Memorandum and Recommendation of the President of the International Development Association to the Executive Directors on a Proposed Grant from the Debt Reduction Facility to the Bank of Mozambique," IDA-R91-81, May 30, 1991.

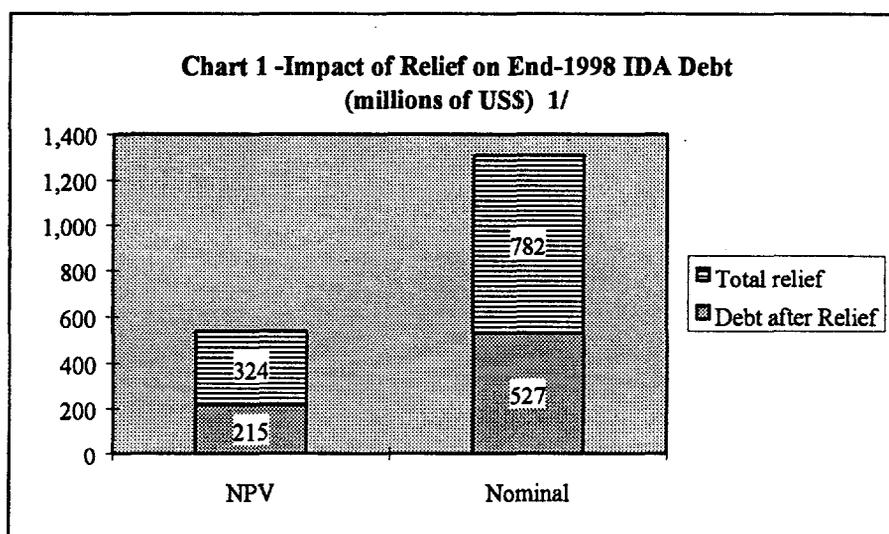
² The principles for the calculation were described in detail in "The HIPC Debt Initiative—Elaboration of Key Features and Possible Procedural Steps," SecM96-927, August 26, 1996, page 11.

**Table 2. Total Relief Delivered During Interim Period and at Completion Point
(millions of US\$, in NPV terms)**

	Interim Period	Completion Point	Total
Relief Under Proportional Burden Sharing	61	234	295
Additional Relief	29	-	29
Total	90	234	324

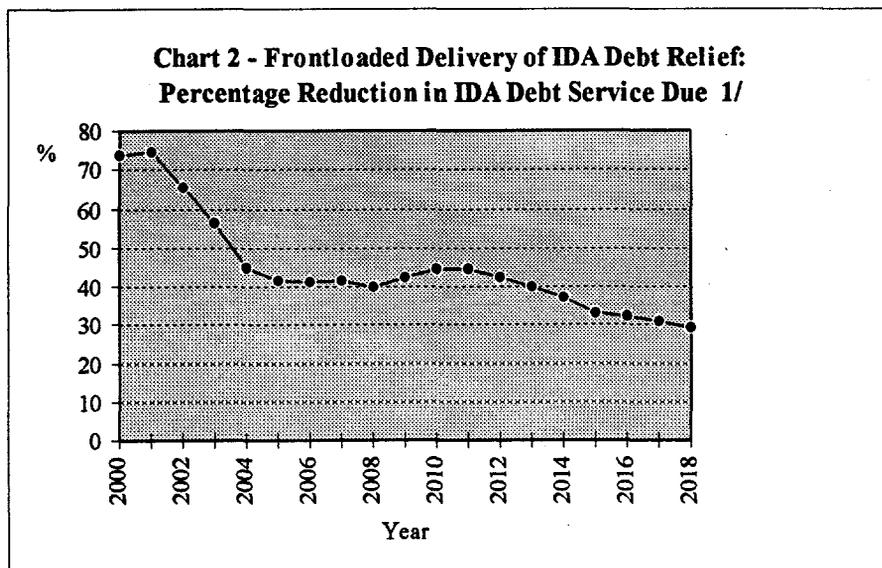
Impact of Interim and Completion Point Measures

8. Table 2 shows total relief from IDA resulting from interim and completion point measures and amounting to up to US\$324 million (of which about US\$29 million would be the additional, voluntary assistance). Total relief would thus be equivalent to a reduction in debt to IDA at end-1998 from a projected US\$539 million in NPV terms before relief to some US\$215 million after relief and from US\$1,309 million to about US\$527 million in nominal terms (see Chart 1).



1/ Includes both interim and completion point measures and about US\$29 million NPV (approximately US\$87 million nominal) in additional voluntary relief.

9. Total savings in debt service resulting from interim and completion point measures would amount to about US\$880 million in nominal terms, including about US\$578 million from the purchase of credits at the completion point. As illustrated in Chart 2, delivery of IDA's assistance as described above would result in a frontloaded profile of debt service reduction, with a 74 percent reduction in debt service in the year 2000 falling to about 29 percent by the end of the projection period.



1/ Includes savings from interim as well as completion point measures. Assumes that the HIPC Trust Fund would purchase oldest IDA credits at the completion point.

IDA ASSISTANCE STRATEGY

10. Since 1987, Mozambique has implemented a wide range of economic reforms with the support of IDA, the IMF, and other bilateral and multilateral donors. The reforms have aimed at reversing the substantial economic decline of the early 1980s, through a shift toward market oriented policies and a sharp reduction in the size of the public sector. The sustained reform effort, the return to peace in 1992, and substantial external donor assistance have led to strong economic growth and a substantial decline in inflation. In 1997, real GDP growth was 8 percent and inflation dropped to 5.8 percent, the lowest since Mozambique's independence in 1975.

11. The Bank's latest Country Assistance Strategy (CAS) for Mozambique was discussed by the Board in December 1997. The CAS supports the Government's program for poverty reduction through sustainable economic growth, emphasizing support to rural areas where most of the poor live. The strategic priorities of the CAS are fully consonant with the development objectives of the HIPC Initiative. These include: (i) promoting rapid, broad-based private sector-led growth -- by supporting the macroeconomic reform agenda, supporting high potential growth sectors, creating a "business-friendly environment", and improving environmental management and assessment; (ii) building capacity and developing human resources -- by increasing Mozambican participation in the private sector, supporting public sector reform and decentralization, and increasing the coverage and quality of health and education services; and (iii) strengthening development partnerships -- by reinforcing the Bank Group/Government partnership, forging closer links with other aid partners, strengthening ties with civil society -- including non-governmental organizations and the private sector -- promoting regional partnerships, and ensuring coordination within the Bank Group. Within these priorities, developing human

resources is receiving special attention in the Government's and Bank's efforts to reduce poverty. In coordination with other participating donors, the Bank is supporting the preparation and implementation of sector expenditure programs in health and education.

12. The CAS objectives will be supported through the implementation of the current portfolio, new financing of about US\$480 million during FY98-00 under the base case scenario, analytical work, aid coordination, policy advice, and technical support. Portfolio performance has improved significantly, reflecting a comprehensive restructuring undertaken jointly with the Government throughout 1997. The proposed new IDA financing is expected to be directed mostly toward investments in agricultural and rural development, education, and infrastructure. Economic and sector work (ESW) will provide the analytical underpinnings for the Bank's program. Two major studies, a Growth Prospects Paper and a Fiscal Management Review, are expected to assist the Government in formulating a medium term development strategy consistent with the changing realities now facing Mozambique. Other studies are aimed at assisting in the development of sector strategies. As part of the proposed assistance to be provided to Mozambique under the HIPC Initiative, IDA will continue to monitor progress made under the Initiative in conjunction with the IMF during the next eighteen months.

THE PROPOSED STRUCTURAL AND SOCIAL DEVELOPMENT PERFORMANCE CRITERIA

Objective of the Proposed Assistance

13. With the proposed assistance, IDA would support the implementation of the Government's economic and social program for poverty reduction as spelled out in the Policy Framework Paper (PFP) for the period 1997-99. IDA's assistance, in conjunction with that of other creditors, would allow Mozambique to reach a sustainable debt position at the completion point.

Proposed Monitoring Criteria

14. The delivery of debt relief at the completion point would be contingent on the successful implementation of the monitorable actions specified in the final HIPC document. Before reaching the completion point, the Government would need to make satisfactory progress in the areas of structural reform, social sector reform, and poverty reduction.

15. **Structural Reforms.** The Government would implement the policy measures detailed in Table 5 of the final HIPC document. A main focus of the reform agenda during the 1998-99 period will be on privatization, public enterprise reform, and fiscal reform. Progress on the implementation of these reforms would be monitored under IDA and IMF-supported programs. Key reforms to be implemented by mid-1999 include:

- completing the privatization program for public enterprises;
- concessioning of *Caminhos de Ferro de Moçambique* (CFM)-- state ports and railways-- to private operators;
- privatizing the management of the five major urban water companies;
- establishing a company with private sector participation to take over the oil importing function of the *Empresa Nacional Petróleos de Moçambique* (PETROMOC)--state oil company; and
- introducing a Value Added Tax (VAT).

16. **Social Sector Reforms.** The Government would undertake measures in the social sectors aimed at improving the health and educational status of the Mozambican population. These measures will be implemented and monitored under sector expenditure programs supported by IDA and other donors. Both the ongoing Health Sector Recovery Program (in place since 1995) and the planned Education Sector Program (under preparation for approval in late 1998) aim at substantially improving the quality and coverage of social services, especially in the areas of primary education and primary health care. Assistance delivered under the HIPC Initiative -- both general budgetary relief resulting from the Initiative as well as IDA's interim relief through grant financing of the Education Sector Program -- will support not only the expansion of social sector infrastructure, but also reinforce the sustainability of recurrent cost financing associated with the expansion.

17. The Government's overall objective is to improve social indicators to at least match the average among Sub-Saharan African countries by the turn of the century. Specific measures and monitorable targets through the year 2000 are detailed in Appendix Table 5 of the final HIPC document. Key measures and targets³ to be achieved by mid-1999 include:

In Education

Measures:

- approving an integrated sector expenditure program for education, in coordination with participating donors;
- ensuring that teacher training keeps pace with recruitment;
- establishing systematic monitoring of internally and externally financed expenditures; and
- raising the share of education in the recurrent budget in line with the Medium Term Expenditure Framework.

Targets: increase the primary gross admission rate (75 percent in 1996) by 2-3 percentage points a year; increase the number of primary school teachers by about 10 percent a year; maintain the availability of textbooks to one per pupil; increase primary completion rates by at least one percentage point a year (6 percent in 1996).

³ Based on medium term targets for the year 2000.

In Health

Measures:

- undertaking a comprehensive review of the ongoing Health Sector Recovery Program, in coordination with participating donors;
- improving the supply of essential drugs and trained staff at first level facilities;
- establishing systematic monitoring of internally and externally financed expenditures; and
- raising the share of health in the recurrent budget in line with the Medium Term Expenditure Framework.

Targets: increase in vaccination coverage of DPT(3)⁴ to 60-65 percent (from 58 percent in 1996); increase in the proportion of health posts/centers stocked with the Essential Drug Kits from 40 to over 50 percent; increase in the proportion of health posts/centers staffed with trained personnel from 70 percent to over 80 percent.

18. **Poverty Reduction.** The Government would also aim at improving the statistical information on the poor, including completing the first comprehensive Poverty Assessment for Mozambique, as well as developing an Action Plan designed *inter alia* to improve the targeting of social programs to the most vulnerable groups. This would be monitored in parallel with the ongoing and new activities in the social sectors.

RECOMMENDATION

19. Once Mozambique's other creditors have confirmed their agreement to provide the debt relief envisioned in the final HIPC document, the Executive Directors will be so informed and confirmation will be sought, on a no-objection basis, of the actions approved in principle at this time. Following this confirmation, IDA would enter into a legal agreement with Mozambique for the provision of the agreed relief on debt owed to IDA, subject to Mozambique's fulfilling the conditions approved by the Executive Directors.

20. I recommend that the Executive Directors approve, in principle, the recommendation contained in the Final HIPC Document concerning the eligibility of Mozambique for assistance under the HIPC Debt Initiative, the decision point, the completion point, the NPV of debt-to-export ratio to be achieved at the completion point, the proposed actions by multilateral creditors to achieve these targets, and the performance criteria to be met by Mozambique.

21. I further recommend that the Executive Directors approve, in principle, the recommendations contained in this paper on the amount and manner of debt relief to be provided in respect of debts owed by Mozambique to IDA. In particular, I recommend

⁴ Diphtheria, pertussis, and tetanus.

that Executive Directors approve the NPV debt reduction on IDA debt through the HIPC Trust Fund, the level of IDA grants provided as interim debt relief, the additional, voluntary contribution referred to in paragraph 3(b), and the structural and social development performance conditions that Mozambique would be required to satisfy at the completion point in order to receive debt relief under the HIPC Debt Initiative.

James D. Wolfensohn
President

By: Sven Sandström

Washington, D.C.
March 31, 1998