**PROGRAM INFORMATION DOCUMENT (PID)**

**APPRAISAL STAGE**

December 5, 2013

Report No.: AB7395

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| **Operation Name** | Mozambique – First Programmatic Financial Sector Development Policy Operation |
| **Region** | Africa |
| **Country** | Mozambique |
| **Sector** | Credit Reporting and Secured Transactions (40%);SME Finance (40%);Telecommunications (20%) |
| **Operation ID** | P133687 |
| **Lending Instrument** | Development Policy Lending |
| **Borrower(s)** | GOVERNMENT OF MOZAMBIQUE |
| **Implementing Agency** | Ministry of Finance (MOF)Banco de Moçambique (BdM) |
| **Date PID Prepared** | December 5, 2013 |
| **Estimated Date of Appraisal** | November 14, 2013 |
| **Estimated Date of Board Approval** | March 6, 2014 |
| **Corporate Review Decision** | Following the corporate review, the decision was taken to proceed with the preparation of the operation. |

1. **Key development issues and rationale for Bank involvement**

**Mozambique’s economic performance has been very strong since the end of the Civil War in 1992**. The country’s GDP growth from 1993 to 2012 averaged 7.4 percent. Its strong performance was made possible by sound macroeconomic management, large-scale foreign-investment projects (“megaprojects”), and significant donor support. These factors contributed to robust growth across most sectors of the economy, especially mining, electricity and services. Although the relative growth rates of different sectors were highly uneven, overall growth has been stable and consistent. Mozambique is also poised to receive massive foreign direct investment (FDI) inflows, specifically from extractive industries.

**However, over the past decade, rapid growth has not translated into significant poverty reduction, and the geographical distribution of poverty remains largely unchanged.** Moderate and extreme poverty are concentrated most heavily in rural areas and in the country’s Central and Northern regions. With a population of 23.9 million, per capita income in 2011 was US$535. This is less than 40 percent of the average for Sub Saharan Africa. Poverty reduction has stagnated, with approximately 55 percent of the population deemed poor. As such, the benefits of FDI have yet to translate into broad development outcomes for most of the population (Mozambique ranks 185/187 in the 2012 Human Development Index and 197/210 in global GDP per capita rankings).

**Financial sector development matters for both economic growth and poverty alleviation.** Evidence strongly indicates that if effectively regulated and supervised, financial sector development spurs economic growth, reduces income inequality, and helps to lift households out of poverty (World Bank 2008). This leads to strong positive impact on economic growth over long-term periods (Demirguc-Kunt and Levine 2008).Moreover, financial sector development is also pro-poor (Beck, Demirguc-Kunt and Levine 2004) and is associated with a decline of extreme poverty (Beck, Kunt and Levine 2007).

**In order for Mozambique to achieve broad based growth and for the private sector to generate jobs, it is imperative to deal with the ongoing challenges of access to finance for firms and households**. Access to finance remains one of the defining challenges for the private sector in Mozambique. The 2013-2014 Global Competitiveness Report, which ranked Mozambique 137 out of 148 countries, found that access to financing was the top one constraint for doing business in Mozambique. The 2009 Finscope Household survey for Mozambique found that only 12.7 percent of the population had access to formal financial services. The problems of access to finance are most severe in rural areas where, according to the 2009 Finscope Household Survey, only 5 percent had access to formal financial services.

**Further financial development in Mozambique also implies continuing reforms to promote financial sector stability (crucial to promote access).** In the last ten years Mozambique has implemented notable reforms to promote financial sector stability (please see Financial Sector Section for details). These reforms enabled substantial progress in the strengthening and development of the financial sector, as highlighted in the 2009 FSAP Update. Nevertheless, there still are important pending reforms to promote financial sector stability, including in the areas of banking regulation and supervision and the banking safety net and crisis management frameworks.

**The Government has recognized the importance of Financial Sector Development as part of its Action Plan for Poverty Reduction and its broader reform agenda for improving the business environment.** Towards that end, a number of reforms have been initiated recently that seek to maintain financial sector stability, improve financial sector regulation, strengthen financial sector infrastructure, introduce new non-bank financial institutions, and promote access to financial services by businesses and households. Most importantly, the Government adopted Mozambique’ *Financial Sector Development Strategy 2013-2022* (MFSDS)in April 2013, which provides a vision and a comprehensive and detailed roadmap for reforms in the financial sector.

1. **Proposed Objective(s)**

**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.** This DPO directly contributes to the realization of the Government’s financial sector strategy and the Country Partnership Strategy (CPS). The proposed operation is structured around three pillars: (i) Financial Stability; (ii) Financial Inclusion; (iii) and Long Term Financial Markets. Actions to promote financial stability focus on improvements in banks’ risk management and asset soundness, safety net and crisis management resiliency frameworks, and protecting the integrity of the financial system. Actions to promote financial inclusion focus on strengthening the insolvency and creditor rights frameworks and the credit reporting system, promoting branchless banking, improving payment systems and, strengthening consumer protection. The long term financial markets policy area promotes the development of money, debt, and capital markets. The DPO series will be accompanied by technical assistance to be provided by the Bank and donor partners in a coordinated fashion.

1. **Preliminary Description**

**The development objective of this operation is to reinforce financial stability, increase access to finance by households and firms, and foster the development of long-term financial markets.** The PDO contributes directly to MFSDS vision and its strategic objectives. The PDO has been designed considering the findings of relevant research (including the FSAP Update) and complements other relevant projects. This PDO has also been informed by experience in other developing countries facing similar challenges, which have been supported by DPOs along with TA with strong achievements.

**This is proposed as a programmatic single-tranche operation in the amount of $25 million.** The proposed DPO is currently envisaged as a series of two operations for the Bank fiscal years FY14 and FY15. The tentative allocation for the first year is US$25 million. The programmatic approach would allow providing more adequate support to MFSDS, which is a long-term strategy (covering 2013-2022) and enhance the development impact of Bank support. DPO II would support additional reforms on financial sector stability, access and long-term markets, including those that are necessary to obtain the full desired impact of reforms included in DPO I. A strong TA program will increase readiness for achieving reforms to be supported under DPO II and beyond. The implementation of relevant financial sector reforms will also take place beyond the timing of DPO II. The Bank will keep supporting this reform process through TA. Within the context of this broader program, the team will also discuss potential additional support with the Government for the year 2015 and beyond, following guidance received during the review process of this operation.

1. **Poverty and Social Impacts and Environment Aspects**

*Poverty and Social Impacts*

**Over the last 20 years Mozambique has had one of the world’s highest rates of GDP growth but there is growing evidence that macroeconomic success has not delivered unambiguous socioeconomic benefits at the household level (Jones and Tarp 2012).**  Mozambique remains one of the poorest countries in the world and it is increasingly recognized that its growth has become less pro-poor over time (DNEAP 2010 and Arndt et al 2012). As a result, consumption poverty rates have remained persistently high. This is especially true in the rural sector, suggesting a widening urban-rural gap and upward pressure on income inequality. While Mozambique has continued to experience a general decrease in poverty, this has been heavily concentrated in urban areas, where only 30 percent of the population resides (Alfani).Meanwhile, rural poverty has remained largely intractable with the notable exception of rural areas in the greater Maputo regions. By promoting financial sector development and increased access in underserved areas, this operation promotes pro-poor growth and benefits rural areas.

**According to a recent study by the United Nations University (Jones and Tarp 2012), rapid macroeconomic growth has not been accompanied by a transformation of the labor market.** The economy has failed to generate sufficient high quality jobs that effectively translate macroeconomic growth into welfare gains. Mozambique’s population tends to be young and rural and is growing rapidly. The majority of Mozambicans earn a living from smallholder agriculture and the very low productivity of these activities is a key reason why poverty remains high. The population remains largely located in rural areas. While unemployment is low, underemployment is high. The informal sector is large and the principal locus of new job creation. Levels of education remain low. Structural change in the labor market has been limited as the share of the work force in agriculture remains persistently high at over 80 percent while that of manufacturing has stagnated in relative terms at below 4 percent. Productivity gaps between sectors are large and widening and this is largely due to the slow productivity growth in agriculture. The primary sector, dominated by agriculture, has the lowest productivity. Spatial differences in the distribution of labor are large with the central and northern regions having the bulk of the agricultural workforce and overall population and the urban south having the bulk of non-primary workers.

**The proposed operation is expected to have positive social and poverty impacts by promoting financial sector development and none of the prior actions it supports is expected to have negative effects on the poor.** 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).** A growing body of empirical research shows that the services provided by the financial system exert a first order impact on long-run economic growth. The level of banking development and stock market liquidity exert an independent positive influence in economic growth. On the other hand, cross country evidence has shown that the poor gain as much from economic growth than the remainder of the population (Dollar and Kraay 2000).

**Financial sector development is also pro-poor (Beck, Demirguc-Kunt and Levine 2004).** While not conclusive, an accumulative body of 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 than rich individuals and larger firms. For households, evidence suggests that financial development facilitates consumption smoothing and investment in human capital. For firms, increased access to finance is associated with higher returns and better performance. Similarly, theory provides sound reasons for believing that the poor disproportionately benefit from financial development (even when not unambiguous). Financial development facilitates entrepreneurship by people with promising ideas but little collateral and income, provides access to risk management and insurance and boosts economic activity that stimulates the demand for labor among others (Demirguc-Kunt and Levine 2009).

**Financial sector development is also associated with a decline of extreme poverty (Beck, Kunt and Levine 2007).** Countries with higher levels of financial development have experienced swifter reductions of the population living on less that $1 per day during the 1980s and 1990s. The magnitude of the impact is also large, with almost 30 percent of the variation across countries in rates of poverty being attributed to cross-country variation in financial development.

**Financial sector development reduces income inequality by disproportionately boosting the income of the poor** **(Beck, Demirguc-Kunt and Levine 2004).** Improvements of the formal financial sector exert a particularly beneficial impact on the economic opportunities of the poor (Demirguc-Kunt and Levine 2008). Furthermore, evidence suggests that the indirect effects of finance on inequality are substantial (Demirguc-Kunt and Levine 2009). Financial development exerts a disproportionately large effect on the poor by expanding labor market opportunities. For micro and small firms, the indirect effects of financial development are significant as small firms benefit more from access to finance and increased growth opportunities than larger firms.

**Prior actions under Pillar 1 of this DPO will contribute to a stable financial system, thereby benefiting the poor to a greater extent.** First, financial sector stability is a pre-condition for financial sector development and increased access to financial service by the poor.Second,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 due to the crisis, this often leads to cuts in public outlays on social programs, transfers to households, wages and salaries among others. In this context, financial crisis are associated with deterioration in poverty indicators**.**  Macro and microeconomic data show an increase in poverty due to financial crisis, with transmission channels such as inflation, unemployment, government spending and lower growth. On the other hand, financial crisis can be costly and the direct costs of banking collapses have largely been shouldered by governments (and, ultimately tax payers). In Mozambique, during the late 1990s and early 2000s, the failure of two state-owned banks imposed significant costs on taxpayers and diverted scarce public resources that could have been used to deliver poverty reduction programs.

**Under Pillar 2, 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. In Mozambique, the 2012 survey of manufacturing firms indicated that smaller firms are especially credit constrained (59 percent of micro-firms indicated access to finance as a top constraint to operations, compared to 50 percent of small firms and 40 percent of medium firms).

**This operation is expected to contribute to increasing women’s access to finance.** Promoting innovations and improvements in financial products and delivery models would benefit women in particular since they have more time and mobility constraints than men. Reforms to strengthen financial consumer protection would also benefit women, who are more vulnerable than men and have lower financial knowledge and skills than men. In addition, reforms to strengthen financial infrastructure can improve access and usage of financial services by women, in particular: credit reporting systems, secured transactions frameworks (women tend to have more movable assets), and the systems, oversight, and delivery mechanisms for retail payments (mobile banking, agent banking products would especially benefit women with more time and mobility constraints). Pillar 2 (Financial Inclusion) is expected to ease socio-cultural barriers by lessening accessibility conditions while broadening/diversifying (i.e. pillar 3 below) the spectrum of banking services.

**Developing long-term financial markets (Pillar 3) will contribute to the diversification of funding sources for business, thereby stimulating 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 financial sector; auctions of the government securities and the announcement of auctions results will improve price discovery and efficient pricing of financial instruments; and announcements of the purpose of each issuance of TBs will reduce fragmentation of government securities.

**In sum, the specific prior actions supported by this DPO series are expected to be particularly beneficial for the poor, women in rural areas, and small enterprises:**

* Credit bureaus will allow individuals and firms to build credit history while helping banks to better assess risks. This should contribute to increased access and affordability of financial services. Better credit information is particularly beneficial for individuals and enterprises with little or no collateral (i.e. smaller enterprises). Moreover, better credit information is associated with higher levels of bank credit and lower financing obstacles for firms.
* Reforms to expand mobile banking and e-money will also have a positive impact on vulnerable groups. For example, the increased use of electronic systems to process social security and pension benefits will reduce the transactions costs (e.g., travel costs) currently imposed on social security and pension recipients. Mobile banking will facilitate the expansion of financial services (including payments and deposits) to rural areas.
* The reforms on consumer protection and transparency of financial information will be particularly helpful for less sophisticated consumers.
* The establishment of a DGF is expected to minimize the fiscal costs associated with the resolution of financial institutions and protect the savings of smaller depositors.
* The development of a robust AML/CFT framework has the potential to reduce poverty by increasing transparency and reducing corruption.
* Finally, the insolvency reform will contribute to an efficient resolution of failing firms, which should protect jobs and increase economic efficiency.

*Environment Aspects*

**The detailed description of this operation suggests that no negative environmental impacts are foreseen**. This project is mainly tailored towards building the technical capacity of the various stakeholders nationwide to access financial services. This could generate the creation of many localized and easy to implement businesses (small scale income generating activities, such as flower growing, horticulture, agriculture, etc.). These efforts will be easily accompanied by the Government, particularly the Ministry of Agriculture (MINAG) and the Coordination of Environmental Affairs (MICOA). MICOA has both a set of environmental and social regulation, as well as sufficient technical capacity to accompany such micro-projects likely to be funded by financing services.

**This operation is not expected to have any negative environmental and social impacts.** The team will seek guidance from the World Bank social safeguards specialist to ensure other non-safeguards related social development actions are taken into consideration to make the project socially and environmentally sound. The World Bank Social Development Specialist will work collaboratively with MICOA counterparts to ensure that due attention is been given to these environmental and social development issues during supervision missions and throughout project implementation timeframe.

1. **Tentative financing**

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| Source: | ($m.) |
| BORROWER/RECIPIENT | 0 |
| International Development Association (IDA) | 25 |
| Borrower/Recipient |  |
| IBRDOthers (specify) |  |
|  Total | 25 |

1. **Contact point**

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