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AGENDA**

EBS/82/40

CONFIDENTIAL

March 10, 1982

To: Members of the Executive Board

From: The Secretary

Subject: Somalia - Stand-By Arrangement - Review and Program
for January-June 1982

Attached for consideration by the Executive Directors is a paper on the review and program for January-June 1982 of the stand-by arrangement for Somalia. A draft decision appears on pages 22 and 23.

This subject will be brought to the agenda for discussion on a date to be announced.

Att: (1)

INTERNATIONAL MONETARY FUND

SOMALIA

Stand-By Arrangement: Review and Program for January-June 1982

Prepared by the African Department and the Exchange and
Trade Relations Department

(In consultation with the Fiscal Affairs, Legal, and
Treasurer's Departments)

Approved by J.B. Zulu and W.A. Beveridge

March 9, 1982

I. Introduction

On July 15, 1981 the Fund approved Somalia's request for a one-year stand-by arrangement, in support of a financial program ending June 30, 1982, in an amount equivalent to SDR 43.13 million, or 125 per cent of Somalia's quota (EBS/81/146, Supp. 1). Of the total, SDR 20.49 million (59.4 per cent of quota) is to be provided from ordinary resources and SDR 22.64 million (65.6 per cent of quota) from borrowed resources. So far, under this arrangement, Somalia has purchased SDR 25.88 million. In accordance with the terms of the stand-by arrangement, a Fund mission ^{1/} visited Mogadiscio during November 30-December 9, 1981 to review with the Government of Somalia the performance under the financial program as well as to reach understandings regarding economic and financial policies and to set the performance criteria for the second half of the one-year stand-by arrangement. In the annexed letter, dated December 9, 1981, the Minister of Finance and the Governor of the Central Bank of Somalia outline the progress made in implementing the financial program and propose certain targets, including performance criteria, for the remainder of the program period, January 1-June 30, 1982.

Somalia's use of Fund resources under the existing stand-by arrangement is summarized in Table 1. The Fund's holdings of Somali shillings, as of December 31, 1981, amounted to 184.9 per cent of quota. Although Somalia has observed the end-December performance criteria, the third purchase under the stand-by arrangement can be made only after the Fund has approved the proposed program and the modification in the coverage of the dual exchange system. This purchase, amounting to SDR 10.78 million,

^{1/} The staff mission consisted of Messrs. S. Nsouli (head-AFR) and J. Buyse (AFR), Ms. N. Calika (AFR), Mr. T. Murakami (ETR), Mr. R. Schneider (FAD), and Ms. P. Berberoglu (secretary-AFR).

will increase the Fund's holdings of Somali shillings to 216.1 per cent of quota. As Somalia has included certain receipts in the nondepreciated foreign exchange market and consequently modified the multiple currency practice approved by the Fund (SM/81/147, Supp. 1), the proposed decision on pages 22 and 23 seeks Fund approval of this change described in Section IV.3 below until June 30, 1982. A further drawing of SDR 6.47 million, increasing the Fund's holdings of Somali shillings to 234.9 per cent of quota, can be made in May 1982 based on the observance of the March 31, 1982 performance criteria.

Table 1. Somalia: Use of Fund Credit During the Stand-By Arrangement, July 1, 1981-June 30, 1982

(In millions of SDRs; end of period)

	1981		1982	
	July	November	March	May
Purchases				
Ordinary resources	7.75 ^{1/}	4.90	4.90	2.94
Borrowed resources	<u>7.35</u>	<u>5.88</u>	<u>5.88</u>	<u>3.53</u>
Total	15.10	10.78	10.78	6.47
Repurchases	--	--	--	--
Net purchases	15.10	10.78	10.78	6.47
Total Fund holdings (cumulative)	53.01	63.79	74.57	81.04
Total holdings as per cent of quota	153.65	184.90	216.14	234.90

Sources: Treasurer's Department; and staff estimates.

^{1/} Includes SDR 5.22 million in the first credit tranche.

A summary of Somalia's relation with the Fund is provided in Attachment I.

II. Background

In recent years a number of exogenous factors, including a severe drought (1974-75), regional hostilities (1977-78), and an ensuing influx

of refugees, have adversely affected the growth of the Somali economy and contributed to the exacerbation of internal and external financial imbalances. In 1979, primarily as a result of larger outlays for refugees and defense, the overall budgetary deficit increased by 50 per cent. More than two thirds of this deficit was financed by the Central Bank, causing net domestic credit to expand by about 72 per cent and domestic liquidity by 37 per cent. Moreover, economic growth continued to remain low, due to a drop in real capital formation, inadequate price incentives, an outflow of Somali workers abroad, and increasing technical and financial difficulties encountered by public enterprises. The rising excess demand pressures in the economy were also reflected in a more than doubling in the rate of inflation and in a tripling in the current account deficit. The overall balance of payments recorded an unprecedented deficit of US\$99 million, causing gross official reserves to decline from about 8 months of official imports at end-1978 to less than 2 months of imports at end-1979.

In response to these difficulties, at the beginning of 1980 the Somali authorities adopted a program, supported by a one-year stand-by arrangement in the first and second credit tranches. The emphasis of the program was on restrained fiscal and monetary policies. In addition, the program provided for an increase in the producer prices of a number of agricultural products in order to stimulate production. Although the financial program's ceilings on net bank credit to the Government, net domestic assets of the Central Bank, and external debt were exceeded and drawings under the stand-by arrangement were, accordingly, limited to only the first purchase, some improvement in economic performance and financial management was achieved. In the fiscal sector the increase in expenditures was contained, with the result that the overall government deficit was slightly reduced and recourse to bank financing declined. This development, in turn, facilitated the pursuit of a tighter monetary policy. Domestic credit expansion decelerated to 31 per cent from 72 per cent, and the rate of growth of domestic liquidity declined to 20 per cent from 37 per cent in 1979. The inflation rate, however, nearly tripled in 1980, reaching almost 60 per cent, due to the build-up in excess demand pressures over the previous years and the sharp rise in the domestic prices of imports brought in through the parallel market. However, the restrained financial policies resulted in a containment of imports to about the 1979 level, contributing to a narrowing in the trade deficit. Together with a substantial increase in net transfers, due to a step-up in international assistance for refugees and grants for development projects, the current account deficit was reduced by about 50 per cent. With net capital inflows remaining at about the 1979 level, the overall balance of payments deficit was substantially narrowed. Nonetheless, gross official reserves continued to decline, reaching the equivalent of three weeks of official imports at end-1980. Further, Somalia began to accumulate external debt arrears.

The Somali shilling had been officially pegged to the U.S. dollar from December 1973 to June 1981 at So. Sh. 6.295 = US\$1. Between 1973 and 1980 the effective exchange rate index, as measured by the import-weighted

index, in foreign currency terms, rose by 17 per cent in nominal terms and 79 per cent in real terms (Chart I). The pressures on official foreign exchange reserves and inadequate supplies of imported consumer goods had led the authorities in the mid-1970s to authorize own-foreign exchange (franco valuta) imports. In connection with this trade, a substantial parallel market for foreign exchange evolved, where the Somali shilling sold at a lower rate in foreign currency terms; foreign exchange was supplied to the market by emigrant Somali workers in the Gulf area and by livestock exporters. The latter obtained the foreign exchange by under-invoicing their exports. As the disequilibria in the economy increased, the scope of the franco valuta system widened. By 1980 nearly 20 per cent of imports were being channeled through the franco valuta system, where the shilling was sold at less than half of the official rate. The system, which generated distortions and contributed to inflationary pressures, deprived the authorities of the foreign exchange that would otherwise have been channeled through the banking system and of control over the consumption-investment mix of imports.

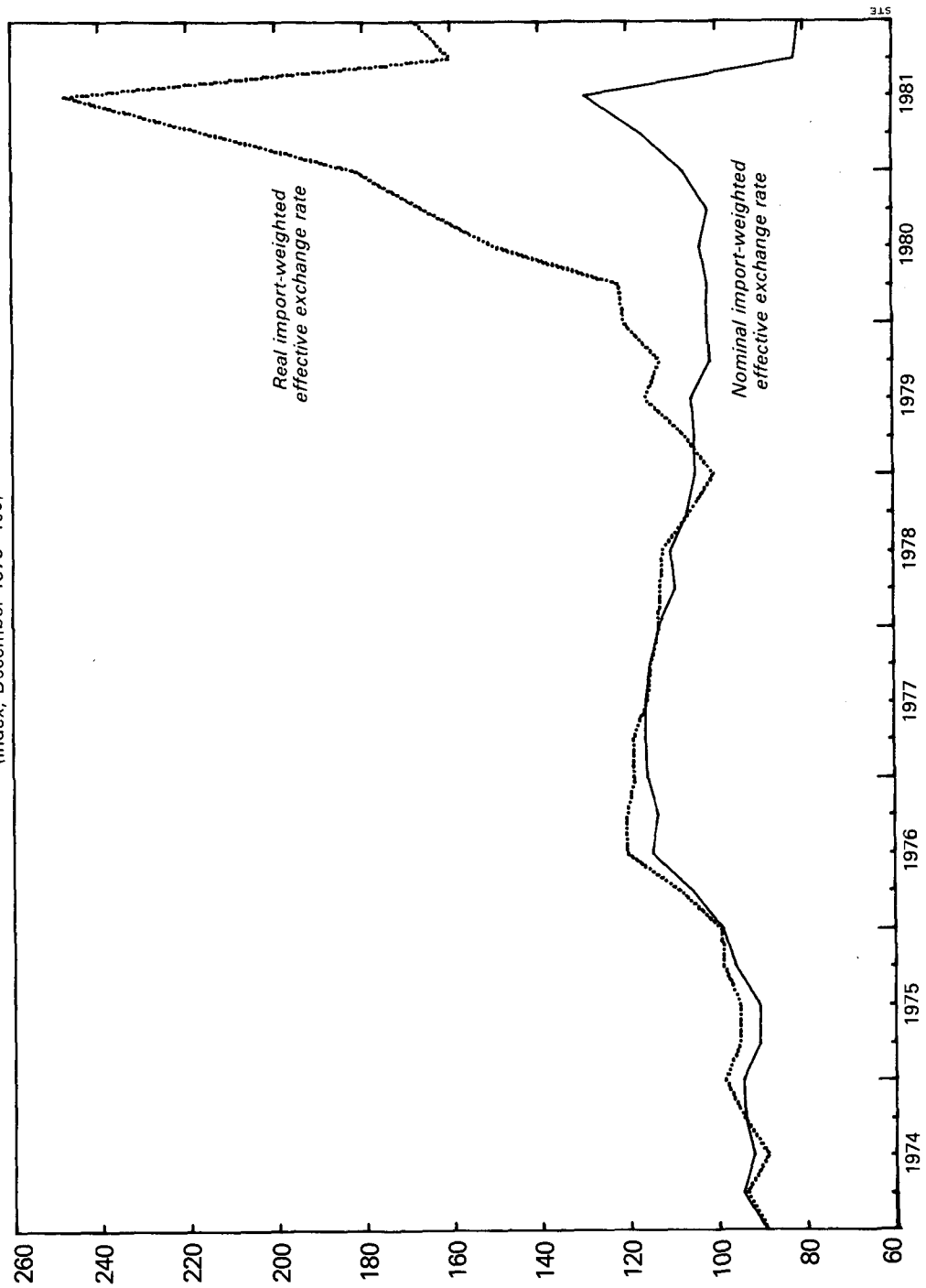
III. Review of Developments and Performance in 1981

The broad objectives of the Government's economic policies in 1981 were to stimulate domestic production, slow down the rate of inflation, and make progress toward the achievement over the medium term of a sustainable external sector position. Without a major shift in policy stance, however, the prospects for progress toward these objectives appeared to be largely unfavorable at the beginning of 1981. Nevertheless, during the first half of 1981 no major policy initiatives were taken. In view of the mounting imbalances facing the economy, however, the authorities decided to adopt at mid-year a major stabilization program supported by a one-year stand-by arrangement from the Fund.

The program included measures on both the supply and demand sides. On the supply side, the key measure involved the devaluation of the Somali shilling effective June 30, 1981 by 50 per cent in foreign currency terms (to So. Sh. 12.59 = US\$1) for all foreign exchange transactions, except the imports of specified essential goods, ^{1/} which would continue to be imported at the previous rate (So. Sh. 6.295 = US\$1). Simultaneously, the Government ceased issuing licenses for franco valuta imports, with the objective of rechanneling foreign exchange transactions through the banking system. In addition, reflecting the exchange rate action, the producer

^{1/} These were defined to include basic foodstuffs, medicines, chemicals, manufactured raw materials, spare parts, and agricultural inputs. Basic foodstuffs were limited to rice, sugar, pasta, flour, tea, coffee, edible oil, dates, maize, sorghum, and wheat. The specified essential goods were estimated to have amounted to about 30 per cent of total imports in recent years.

CHART I
SOMALIA
MOVEMENTS IN EFFECTIVE EXCHANGE RATES 1973-81¹
(Index, December 1975 = 100)



Source: Staff calculations. For the second half of 1981, account is taken of the dual exchange rate system.
¹Import-weighted. Increase indicates appreciation, decrease indicates depreciation.

price of bananas, the second major export commodity, was more than doubled. The producer prices for most key agricultural products had been increased by 30 to 50 per cent in April (Appendix Table V). The Government also decided to reassess the position of public enterprises with a view to improving their productivity and profitability. In this connection, it was decided, in principle, to maintain in operation only enterprises determined to be viable, primarily on efficiency considerations. Efforts were also to be exerted to strengthen the development planning process, with a view to preparing a Five-Year Development Plan (1982-86) that would provide an appropriate framework for medium-term adjustment efforts. On the demand side, the Government decided to tighten sharply its fiscal and credit policies with a view to reducing the level of aggregate demand. Furthermore, in order to improve resource allocation, mobilize domestic savings, and enhance the process of financial intermediation, the interest rate structure was revised upward. To monitor the performance under the program, quantitative criteria for the first two quarters of the program period were included on (1) net domestic credit, (2) net credit to the Government, (3) losses arising from the dual exchange rate market transactions, (4) external payments arrears, and (5) external debt contracted or guaranteed by the Government with a maturity of 1 to 12 years, excluding any refinancing loans obtained through negotiations.

In light of the policies pursued, as well as extremely favorable weather conditions, the performance of the Somali economy during 1981 was considerably better than originally envisaged. Agricultural output is estimated to have reached a record level. The budgetary deficit was nearly halved, while the rate of growth of domestic credit was reduced by 45 per cent. In addition, preliminary data indicate that the current account deficit of the balance of payments declined to about two thirds the 1980 level and the overall balance of payments deficit was reduced (Table 2 and Chart II).

Although there are no national income accounts data for Somalia, there are indications that the economy expanded at a moderate pace in 1981. This expansion occurred largely in the agriculture and livestock sectors. Although official estimates for production of cash crops are not yet available, the spring harvest was generally regarded as the best of the last decade, primarily due to the good weather conditions as well as the increase in producer prices. It is estimated that production of maize and sorghum, the two main food crops, increased by about 13 per cent. After declining for several years, there are indications that there was also a reversal in the trend of banana production during the second half of 1981. With the doubling of producer prices at mid-year, financial incentives to banana producers were considerably improved. Coupled with improvements in management and shipping facilities, banana exports more than doubled during the second part of the year. There are no reliable data on the size of the herd or on domestic consumption of livestock. Preliminary estimates of export data indicate, however, that livestock exports for the year exceeded the record level of 1980. The industrial sector is expected to have recorded

Table 2. Somalia: Selected Economic and Financial Indicators, 1980-82

	1980		1981		1982		1981/82 Program		
	Actual	Projection	First half Actual	Second half Actual	Year Actual	Projection	First half Projection actual	Second half Projection	Year Projection
(Growth rates in per cent from previous year or half year)									
Consumer price index									
Average	59.4	35.0	21.2 1/	9.2	45.4	17.0	...	8.0	24.4 2/
End of period	69.1		20.9	5.7	27.8				
Trends in central government finance									
Total revenue and grants	4.8	61.6	-7.7 3/	111.8	44.0	29.1	49.6	111.8	94.7 4/
Total expenditure	1.8	33.2	-18.0 3/	63.3	8.0	17.5	37.4	63.3	40.7 4/
Overall deficit	-2.3	-7.8	-32.8 3/	-32.8	-43.8	-27.8	11.4	-32.8	-48.8 4/
Overall deficit/Total expenditure (ratio)	40.9	28.4	33.5 3/	13.8	21.3	13.1	25.8	13.8	13.7 4/
Trends in monetary aggregates									
Money and quasi-money	20.2	14.0	19.5	3.0	23.1	13.2	19.3	3.0	6.7
Net domestic credit	31.2	17.3	18.4	-1.1	17.0	22.6	6.5	-1.1	11.0
Government (net)	54.5	18.6	19.7	-1.2	18.2	9.9	5.0	-1.2	6.5
Private	14.6	16.0	17.1	-1.1	15.8	35.2	8.0	-1.1	17.9
Net domestic assets	29.7	49.0	21.6	3.7	26.1	27.0	32.8	3.7	16.7
Net foreign assets	-54.5	-769.9	-27.5	-21.1	-42.8	-667.5	-140.7	-21.1	19.7
Interest rate (annual rate, one year savings deposit)	5.5	7.5	5.5	7.5	7.5	7.5	7.5	-579.3	-478.0
									7.5
Trends in the external sector									
Exports, f.o.b.	29.2	25.7	-38.9 5/	91.2	6.5	20.7	49.9	91.2	23.9 6/
Imports, c.i.f.	3.2	20.3	-36.0 3/	44.5	-21.7	14.9	3.0	44.5	7.6 4/
Non-oil imports, c.i.f.	-3.7	...	-32.5	10.4	-29.0	31.2	...	10.4	-2.1 4/
Nominal effective exchange rate (depreciation -)	0.2	...	17.7	-33.7	-6.4	...	...	-33.7	...
Real effective exchange rate (depreciation -)	35.7	...	33.0	-29.1	21.6	...	...	-29.1	...
Current account	-73.6	-139.8	-10.9	-36.5	-47.4	-68.9	-33.1	-36.5	-84.6
Balance of payments	-27.7	-100.1	-6.3	-10.1	-16.4	-43.9	-13.2	-10.1	-48.2
Gross official reserves (months of non-franco valuta imports, c.i.f.)	1.1	...	2.1	1.4	1.8	...	...	1.4	...
External payments arrears	44.6	37.0	71.3	15.5	15.5	--	37.0	15.5	--

Source: Based on data provided by the Somali authorities; and staff estimates.

1/ Over second half of 1980.

2/ Over 1980/81.

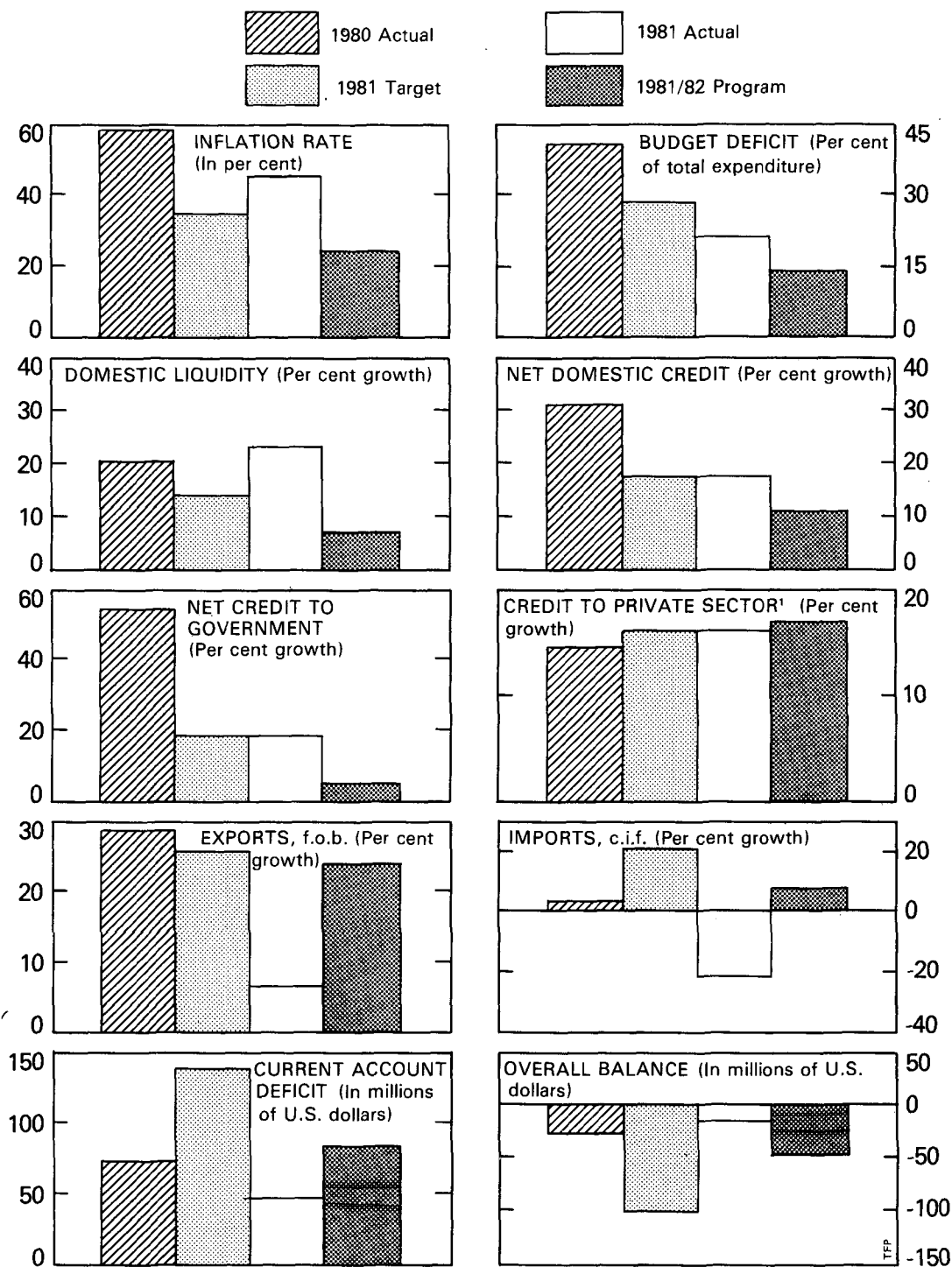
3/ Based on average of each half in 1980.

4/ Based on average of each half in 1980 and first half of 1981.

5/ Based on second half of 1980 on the assumption that 40 per cent of 1980 exports occurred during the first half and 60 per cent during the second half of 1980.

6/ Based on second half of 1980 as explained in footnote 5 and first half of 1981.

CHART 2 SOMALIA FINANCIAL INDICATORS, 1980-82



Sources: Data provided by the Somali authorities and staff estimates.

¹Including public enterprises.

a decline in production, due mainly to the continued closure of the oil refinery. Further, floods early in the year reduced production in the sugar refining industry to about 20 per cent of capacity.

The rate of inflation dropped from about 60 per cent in 1980 to about 45 per cent in 1981. The deceleration took place mainly in the second half of 1981. During the first half of 1981 inflation reached an average annual rate of about 50 per cent. Due to the intensification of demand management measures, the marketing of the record harvest, as well as a step-up in franco valuta imports licensed prior to June 30, 1981, food prices started to drop during the second half of 1981; after peaking in July, the price index declined in August and did not revert to the July level until the end of the year. For the second half of 1981 the annual rate of inflation is estimated at about 19 per cent. The impact on inflation of the dual exchange rate system introduced during the second half of 1981 was limited, due mainly to two factors. First, imports through the franco valuta market were already priced at a depreciated rate. Second, imports of specified essential goods continued to be imported at the previous official exchange rate (So. Sh. 6.295 = US\$1).

The fiscal position improved considerably during 1981 (Appendix Table I). Based on preliminary estimates for 1981, the budgetary deficit was reduced from about 41 per cent of expenditures in 1980 to about 21 per cent in 1981 compared with a program target of 28 per cent. Domestic financing of the budget declined by 51 per cent and foreign financing by 33 per cent. Most of the improvement took place during the second half of 1981. The deficit dropped from 34 per cent of expenditures in the first half to 14 per cent in the second half. Revenues and grants, which declined during the first half of 1981, rose sharply in the second, leading to a 44 per cent increase over the year compared with a targeted increase of 62 per cent. The increase that took place reflected largely the doubling of import duties revenue due to the effect of the devaluation on predominantly ad valorem import taxes and an increase in the volume of own-foreign exchange imports. However, there were shortfalls in 1981 from original projections in foreign grants (from So. Sh. 525 million projected to So. Sh. 137 million), in excise taxes (from So. Sh. 238 million projected to So. Sh. 96 million), and in collected export taxes (from So. Sh. 236 million projected to So. Sh. 44 million). The shortfall in excise taxes was mainly due to the underutilization of the capacity of the sugar refineries, while that in export taxes was primarily due to the dispute with livestock exporters regarding the 25 per cent ad valorem export tax. The latter had been enacted at mid-year in order to limit the windfall profits for livestock exporters arising from the devaluation and to generate additional revenues for the budget. Although the tax was initially strongly resisted by livestock exporters, negotiations between the Government and livestock exporters led to an agreement on the 25 per cent tax rate but not on the actual export f.o.b. price on which the tax was to be levied. Pending verification of the actual price, the Government decided to levy the tax on the

basis of a minimum export price, which is estimated to be some 40 per cent below the actual price. 1/

Offsetting the shortfall in revenues, expenditures in 1981 are estimated to have increased by only about 8 per cent and to have remained 19 per cent below original program projections. The rise in expenditures reflected mainly the adjustment of 7 to 30 per cent in salaries that took place at the beginning of 1981 and the impact of the devaluation on government expenditures. During the year, spending was reduced, in nominal terms, for health, education, agriculture, mineral development, and transportation. Increases, which took place in the second half of the year, occurred primarily in public works, information, the presidency, and defense. Strict expenditure control was facilitated by the more timely availability of information concerning expenditures, due to a monthly reporting system instituted by the Accountant General on January 1, 1981 as well as a new system accelerating the availability of revenue estimates that is being developed under Fund technical assistance. Further, in order to reduce the burden of public enterprises on the budget, the Government closed three such enterprises in 1981. 2/

With the improved budgetary position, the growth of domestic credit was reduced to 17 per cent during 1981 from 31 per cent in 1980 (Appendix Tables II and III). During the first half of 1981 net domestic credit expanded by 18 per cent, with credit to the Government growing by 20 per cent and to the private sector by 17 per cent. During the second half of 1981 the tightening of credit policy resulted in a reduction of domestic credit by 1 per cent, for both the Government and the private sector. Although, on the basis of data provided by the Somali authorities, the credit targets were met, domestic liquidity increased by about 23 per cent over the year, as compared with the original projection of 14 per cent, due largely to the unexpectedly favorable outcome of the balance of payments.

Although the dual exchange rate system had been expected to have an expansionary impact on domestic liquidity, the impact is estimated to have

1/ Staff estimates indicate that if the 25 per cent ad valorem tax was levied on the basis of the actual export price, and if account was taken of the termination of underinvoicing and the devaluation of the Somali shilling, the actual export price in domestic currency to livestock exporters would have risen by 3 to 5 per cent.

2/ These were the National Agency for Building Materials, the Agency for Textiles and Household Appliances, and the Livestock Development Agency.

been contractionary, as the Central Bank incurred an estimated gain instead of the projected loss in domestic currency terms in its foreign exchange operations. In the course of implementing the dual exchange rate system, the Somali authorities decided to continue exchanging certain receipts of foreign missions accredited to Somalia 1/ and oil-exploring companies 2/ at the original exchange rate. As receipts in the more appreciated market exceeded payments, the Central Bank recorded a net profit of So. Sh. 95 million during the first half of the program period (a net profit of So. Sh. 155 million during July-September and a net loss of So. Sh. 60 million during October-December 1981). This compares with an originally projected loss of So. Sh. 512 million in July-December 1981. In addition to the dual exchange rate effect, other components of "other items net" in the monetary survey declined. Taking account of these factors, net domestic assets are estimated to have increased by only 3.7 per cent during the second half of 1981 and by 26.1 per cent for the year as a whole.

In accordance with their financial program, on June 30, 1981 the Somali authorities increased interest rates on savings and time deposits from a range of 4-7 per cent to 6-9 per cent; the central bank discount rate and the Treasury bill rate from 4 per cent to 6 per cent; commercial bank lending rates from a range of 6-9.5 per cent to 10 per cent; and the Development Bank's medium- and long-term lending rates from a range of 5.5-7.5 per cent to 10-14 per cent. Further, with the objective of attracting the savings of Somali emigrants in the Gulf area, they introduced nonresident accounts denominated in U.S. dollars. Somali workers abroad and any Somali citizen earning foreign exchange abroad were allowed to open these accounts at the commercial bank, either as time or demand deposits. Currently, interest rates up to 11 per cent are allowed on these accounts. Foreign exchange in these accounts may be used to import goods for which import licenses have been issued or as collateral to obtain loans from the commercial bank. A credit facility in Somali shillings of up to 50 per cent on the balance of the nonresident account is provided by the commercial bank. During 1981 only two such accounts were opened.

The balance of payments position improved markedly during 1981 due mainly to the austere financial policies and the improved domestic supply conditions (Appendix Table IV). The current account deficit is estimated to have decreased sharply to US\$47 million in 1981 from US\$74 million in 1980 and an original projection of US\$140 million for 1981; the overall deficit is estimated to have declined to US\$16 million in 1981 from a deficit of US\$28 million in 1980 and a projected deficit of US\$100 million for 1981. Although exports in the first half of 1981 were stagnant, compared to a projected improvement, they grew considerably in the second

1/ With the exception of the salaries of diplomats.

2/ The transactions of certain other foreign companies through non-resident accounts denominated in Somali shillings are also included. These however, involve only marginal amounts.

half of 1981, resulting in an increase of about 7 per cent for the year. Livestock exports rebounded in the second half of 1981, due partly to the strong demand in the Gulf area and some reduction of underinvoicing of exports. Exports of bananas, which account for about 5 per cent of total exports and which had been declining, doubled during the second half of the year, responding to the more-than-doubling in the producer price and improved transportation facilities. However, the major improvement in the external position came from an estimated drop of 22 per cent in total imports. Official imports in 1981 are estimated to have declined by 28 per cent, while franco valuta imports are projected to have registered an increase of 9 per cent. There are indications that, in addition to consumer goods, imports of investment items, such as machinery and transport equipment, were sharply curtailed during 1981. Offsetting in part the improvement in the trade account, official transfers are estimated to have declined more than projected, reflecting a substantial reduction in international assistance. The capital account is estimated to have registered a net surplus of US\$32 million. Notwithstanding the balance of payments deficit, the Central Bank's gross international reserves rose to US\$31 million, equivalent to about 2 months of official imports at the 1981 level, mainly due to purchases from the International Monetary Fund and the Arab Monetary Fund.

With the devaluation of the Somali shilling and the other stabilization measures, the authorities attempted to create the economic conditions to rechannel franco valuta transactions through the banking system. Accordingly, the authorities announced on June 30, 1981 that licensing for franco valuta imports would be discontinued from July 1, 1981 and imported commodities under this system would be allowed to enter the country only until August 14, 1981 if licenses had been already granted. The merchants involved in the system resisted this action and continued to bring into the country own-foreign exchange imports after the expiration date. The authorities, therefore, announced on September 30, 1981 that a penalty, resulting in a doubling of import taxes, would be imposed on franco valuta imports until November 15, 1981 and that thereafter all franco valuta imports would be confiscated. After several shipments had been confiscated, all franco valuta imports ceased.

Through rescheduling repayments, primarily with the Islamic Development Bank, and some cash payments, external payments arrears were reduced from US\$45 million at the end of 1980 to US\$28 million at the end of September 1981 and to US\$16 million at the end of 1981. These amounts were considerably below the program ceilings of US\$41 million at the end of September 1981 and of US\$37 million at the end of 1981.

The performance criteria relating to the contracting or guaranteeing of public external debt for loans with original maturities of one to twelve years were met through the end of 1981, as no such loans were contracted. Loans on concessionary terms, contracted during the first half of the program period, amounted to US\$130 million. However, as disbursed external debt at end-1980 amounted to US\$684 million, debt service payments

rose to US\$27 million in 1981, or 18 per cent of export receipts. At end-1981 disbursed external debt reached US\$716 million.

IV. Policies for the Second Half Year (January-June 1982) of the Program and the Outlook for 1982

While the second half of the program period covers only the period January 1, 1982 to June 30, 1982, the attached letter of the Somali authorities outlines their economic and financial policies for the whole of 1982. During 1982 the authorities intend to continue their stabilization efforts, primarily through a further tightening of financial policies and further progress on the unification of the exchange rate. The budgetary deficit is projected to decrease by a third and the rate of monetary expansion by about one half. While these policies are expected to result in a further slowdown in the rate of inflation in 1982, the balance of payments deficit is expected to increase, due mainly to two factors: (i) the resumption of some imports of investment goods, which had been sharply curtailed in 1981, and (ii) the return of more normal weather conditions, which will necessitate a higher level of imports of foodstuffs.

To assess the performance of the economy during the first half of the program period and the prospects during the second half, the tables provide data broken down by half years. For the one-year program period (July 1, 1981-June 30, 1982), the policies adopted within the context of the program are expected to reduce the rate of inflation to 24 per cent, to limit the current account deficit of the balance of payments to US\$85 million, and contain the overall balance of payments deficit to US\$48 million. These developments reflect the exchange rate action taken, the increases in producer prices, and the favorable weather conditions that prevailed in the first half of the program period, as well as the tight financial policies pursued. The latter provide for a reduction in the rate of growth of domestic credit from 31 per cent in 1980 to 11 per cent during 1981/82 and a cut in the budgetary deficit from about 41 per cent of government expenditures in 1980 to 14 per cent in 1981/82 (Tables 2 and 3 and Chart II).

1. Fiscal policy

The key element in the stabilization efforts of the Somali authorities during 1982 is the further tightening of fiscal policy. During 1982 the authorities intend to take measures on the revenue and expenditure sides that will contribute to a reduction in the budgetary deficit to about 13 per cent of total expenditures from 21 per cent in 1981 (Appendix Table I). Revenue and grants are projected to grow by 30 per cent, while the growth rate of expenditures is expected to be contained to about 18 per cent. Recourse to domestic bank financing is expected to decline by 36 per cent, while net foreign financing will be reduced by 15 per cent. As a proportion of total credit expansion, net credit to the Government will

Table 3. Somalia: Summary of Financial Program
(July 1, 1980-June 30, 1982)

1. Principal objectives

- a. Stimulate domestic production.
- b. Reduce the rate of inflation. Target: 24 per cent in 1981/82 program year.
- c. Progress toward a sustainable external sector position over the medium term. Target: Balance of payments deficit of US\$48 million in the 1981/82 program year.

2. Principal measures

- a. Price policy: (i) Increase producer prices for agricultural products (30-50 per cent in April 1981 and 107 per cent for bananas in June 1981). (ii) Increase gasoline prices by 150 per cent (August 1981).
- b. Wage policy: No cost-of-living increases in public sector.
- c. Development policy: Strengthen development planning process and finalize the Five-Year Plan (1982-86).
- d. Public enterprise policy: Review the position of public enterprises with a view to abolishing enterprises determined to be not viable. Three enterprises abolished in 1981.
- e. Fiscal policy: (i) Impose a 25 per cent ad valorem tax on livestock exports (July 1981). (ii) Implement letter of credit system for import taxation. (iii) Implement monthly expenditure reports and analysis system. (iv) Review public enterprise taxation as recommended by the 1980 IMF tax survey mission. (v) Maintain real expenditure in 1982 at first half 1981 level.
- f. Monetary policy: (i) Curtail credit expansion during the program period. Emphasis on credit to the private sector in the second half of the program period to allow expansion in economic activity. (ii) Increase interest rate structure (June 1981). (iii) Introduce foreign exchange accounts for Somali workers abroad and exporters (July 1981).
- g. External sector policy: (i) Introduce a dual exchange system as a transitory measure (50 per cent devaluation in foreign exchange terms in the depreciated market) toward a unified exchange rate at a realistic level. (ii) Abolish the franco valuta system (announced in June 1981 and ceased in November 1981). (iii) Reschedule and repay payments arrears to eliminate them by the end of the program period.

account for about 22 per cent. The main assumptions on which the projections are based are given in Appendix Table VI.

The projected increase in revenues and grants reflects a number of factors. First, with the resolution of the dispute with livestock exporters, the 25 per cent ad valorem tax on livestock exports will start to generate additional revenues for the budget. To avoid revenue losses through under-invoicing, the Ministry of Finance and the Central Bank are setting up a monitoring apparatus to assure proper invoicing. Revenues from this source are expected to increase by So. Sh. 100 million. Second, most specific import and export duties are being converted to an ad valorem basis, a move that will improve the elasticity of the tax system. Third, with the termination of franco valuta imports, all ad valorem import taxes will be based on the letters of credit required for foreign exchange conversion. This will avoid revenue losses that may have resulted from taxing franco valuta imports on the basis of a valuation list. In addition, the Government will reduce the exemptions on import duties currently granted to some public and private enterprises. These measures are expected to lead to an increase of 4 per cent in customs revenue in 1982 over the unusually high receipts of 1981, which resulted from the sharp rise in franco valuta imports and the penalties on such imports imposed during the third quarter. ^{1/} Fourth, the recovery of the sugar industry from the floods that took place early in 1981 is expected to lead to a sharp increase in excise tax revenues, estimated at So. Sh. 300 million. Fifth, the expected resumption of the operations of the sugar processing enterprises, the devaluation, and the closure of three enterprises in 1981 are expected to have contributed to an overall improvement in the profitability of public enterprises, with the result that revenue from public enterprises is anticipated to increase by So. Sh. 180 million in 1982. Sixth, the Somali authorities are expecting foreign grants (in domestic currency terms) to increase by 38 per cent, primarily due to the full year effect of the devaluation. Seventh, the authorities are expected to continue to strengthen the tax collection process.

It is the policy of the Somali Government to monitor revenues closely during the year and to scale down expenditures in order to avoid the emergence of excessively large budgetary deficits. The 18 per cent increase in expenditures projected for 1982 over 1981 reflects primarily the fact

^{1/} The estimated import tax revenue during the (post-devaluation) second half of 1981 represents a 140 per cent increase over that of the (pre-devaluation) first half of 1981. This is explained by the devaluation effect on the predominantly ad valorem import duties, the increase in imports in the second half compared with the first half, and the doubling of import duties on franco valuta imports that was imposed from September 30 to November 15.

that the 1981 data include data on the pre-devaluation level in the first half of 1981. In fact, the level of expenditures in 1982 is expected to be reduced by 5 per cent below the annual level of expenditures during the second half of 1981. This reduction is to be achieved due to three main factors. First, the Government does not plan to grant any cost-of-living adjustment to the salaries of civil servants during 1982. The last adjustment, which ranged between 7 and 30 per cent, was granted in January 1981. Second, the authorities expect that there will continue to be a reduction in the number of government employees in 1982. Although the Government offers automatic employment to all high school graduates and tenure to all civil servants, the relative decline in salaries in the civil service has reduced the number of applicants and encouraged a number of civil servants to take early retirement. The authorities are of the view, however, that this reduction is not impairing the efficiency of government operations. Third, strict administrative control on spending will continue to be exercised through the mechanism set up in 1981 with Fund technical assistance to improve the flow of information on expenditures on a monthly basis.

In the medium term the objective of the authorities is to ensure a slower growth of expenditures than revenues in order to achieve a balanced budgetary position over the next few years. In this connection, it was noted that budgetary development expenditures have traditionally constituted only a small proportion (7 per cent during 1979-80) of total government expenditures. In addition, the role of the private sector in investment under the new Five-Year Development Plan (1982-86) would be expected to expand considerably, thus limiting the impact on the budget. Regarding revenues, while the scope for substantial increases is limited in Somalia, the authorities noted that the measures taken during 1981, particularly with regard to the conversion of specific import taxes to ad valorem taxes, the increased scope of using the letters of credit for foreign exchange conversion as the basis for customs duties, and the strengthening of tax collection procedures, have contributed to an improvement of the elasticity of the tax system. Nonetheless, during the course of 1982 the Government is expected to review the medium-term recommendations made in the IMF Tax Survey, with a view to undertaking some reforms in the context of the 1983 budget. These include the simplification of the import tax structure, the rationalization of the income tax structure for individuals, the conversion of specific domestic excise taxes into ad valorem taxes, and the development of a sales tax. In addition, the authorities are reviewing their overall taxation policy toward public enterprises. These reforms would be geared to achieve a more equitable distribution of the tax burden and provide greater economic incentives for growth.

2. Monetary policy

In line with the Government's policy of financial restraint, the rate of growth of domestic liquidity is expected to decline to about 13 per cent in 1982 from about 23 per cent in 1981 (Appendix Tables II and III). The growth of net domestic credit is to be contained to about 23 per cent.

While the growth in net credit to the Government is expected to be reduced to 10 per cent, as compared with a growth rate of 18 per cent in 1981, credit to the private sector is expected to grow by some 35 per cent, or about double the rate of 1981. This increase in credit to the private sector is needed to allow for an expansion in domestic private sector activity, as the real level of net domestic credit to the private sector (including public enterprises) declined sharply in recent years, particularly in light of the extremely high rates of inflation recorded in 1980-81. The projected balance of payments outcome for 1982 is expected to exert a substantial contractionary impact on domestic liquidity.

For the 1981/82 program year the ceilings on net domestic credit and the dual exchange rate effect (Table 4) have been set in such a manner that, together with the balance of payments outcome and the expected movement in other items net, the growth rate in domestic liquidity will be at about 7 per cent, as compared with about 20 per cent in 1980 and an annual rate of about 40 per cent in the first half of 1981. The ceilings allow for an expansion in net domestic credit of about 11 per cent during the program year, as compared with 31 per cent in 1980. Net credit to the Government is programed to increase by 5 per cent, as compared with 55 per cent in 1980, and net credit to the private sector is programed to increase by about 17 per cent, as compared with 15 per cent in 1980. The rate of inflation during the program period is projected at about 24 per cent, as compared with about 60 per cent in 1980.

The net monetary impact of the dual exchange rate system during the first half of 1982 is expected to be So. Sh. 59 million. Insofar as the actual sale of foreign exchange for the purchase of specified essential goods is the same in its economic impact as a subsidy of 50 per cent on such goods, and as such sales have an expansionary monetary impact, the program provides a ceiling of So. Sh. 180 million for the first quarter and a cumulative ceiling of So. Sh. 350 million through the end of the second quarter on the sale of foreign exchange. The ceiling, which is effectively on the domestic currency losses to the Central Bank of such sales, excludes any profits from the inclusion of the receipts described in Section III above. These losses and profits will be eliminated when the dual exchange rate system is unified.

As the interest rate structure was substantially revised upward in 1981 and as the rate of inflation is subsiding, the authorities did not consider a further revision necessary at this stage. Nonetheless, they are keeping the interest rate structure under review.

3. Balance of payments prospects and policies

The balance of payments deficit is expected to widen in 1982 (Appendix Table IV). The main assumptions behind the projections are given in Appendix Table VII. With the return to more normal weather conditions, which will necessitate some increase in imported consumption goods, and

Table 4. Somalia: Quantitative Performance Criteria for
July 1981-June 1982 Stand-By Arrangement

	1981			1982	
	June	Sept.	Dec.	Mar.	June
(In millions of Somali shillings)					
Net domestic credit <u>1/</u>					
Ceiling		4,393.0	4,550.0	4,850.0	5,096.0
Actual	4,591.5	4,373.6	4,539.3	...	...
Net credit to Government <u>2/</u>					
Ceiling		2,200.0	2,257.0	2,337.0	2,395.0
Actual	2,276.8	2,196.0	2,249.3	...	...
Foreign exchange loss <u>3/</u>					
Ceiling		512.0	512.0	180.0	350.0
Actual		31.8	201.1	...	...
(In millions of U.S. dollars)					
External payments arrears					
Ceiling		41.0	37.0	8.5	--
Actual	71.3	28.2	15.5	...	...
External debt <u>4/</u>					
Ceiling		25.0	25.0	25.0	25.0
Actual	--	--	--	...	...

Sources: EBS/81/146; and data provided by the Somali authorities.

1/ Credit to the Government, public enterprises, and private sector less government deposits at the Central Bank.

2/ The banking system's claim on the Government, less government deposits, plus any budgetary use of local currency counterpart in respect of purchases from the Fund.

3/ The cumulative gross loss accruing to the Central Bank of Somalia during the calendar year from foreign exchange sales for imports at the rate of So. Sh. 6.295 = US\$1.

4/ New commitments on public and publicly guaranteed external debt with a maturity of between 1-12 years, excluding any refinancing loans obtained through negotiations.

the provision of more adequate credit to the private sector, which will allow the sector to increase its investment activities, it is expected that imports in nominal terms in 1982 will revert to a level approximately 10 per cent below the 1980 level. Although in 1982 export receipts are also expected to rise rapidly (by about 21 per cent), primarily on account of the reduction in underinvoicing of livestock exports and the response of banana exporters to the increase in producer prices, the rise in imports is expected to contribute to a widening of the trade account deficit. Further, private transfers are expected to decline from US\$62 million to US\$50 million in 1982, while official transfers are projected to remain unchanged. ^{1/} The current account balance is therefore expected to widen to US\$69 million. Further, net capital transactions are projected to decline by about 23 per cent contributing to widening in the projected overall balance of payments deficit to US\$44 million. This is expected to be financed by purchases from the Fund, purchases from the Arab Monetary Fund, and some drawdown of reserves.

The dual exchange rate system was introduced on June 30, 1981 as a transitory measure. Under this system, all foreign exchange transactions except for imports of specified essential goods ^{2/} were to take place at a depreciated rate of So. Sh. 12.59 = US\$1 (the second market) while payments for specified essential imports were to be transacted at the rate of So. Sh. 6.295 = US\$1 (the first market). The official buying and selling rates for the U.S. dollar in the first market are So. Sh. 6.2327 and So. Sh. 6.3573, and in the second market, So. Sh. 12.4654 and So. Sh. 12.7146. In the course of implementing this system, certain foreign exchange transactions other than for specified essential imports were included in the first market. These involved mainly receipts for foreign embassies accredited to Somalia (excluding salaries of diplomats) and for oil exploring companies. The transactions of certain other foreign companies through nonresident accounts in Somali shillings were also included in the first market; these, however, involved only marginal amounts. The inclusion of these transactions was not indicated in the multiple currency practice approved by the Board on July 15, 1981. Effective February 27, 1982, transactions involving receipts for foreign missions, certain foreign companies, and transactions through nonresident accounts in Somali shillings were placed in the second market. The authorities are requesting approval of these modifications through end-June 1982. In this connection, the

^{1/} The data for private transfers are not comparable. Since the mid-1970s, private transfers have included the counterpart entry to franco valuta imports financed by remittances from Somali workers abroad and by foreign exchange provided by livestock exporters. With the abolition of the franco valuta import system, private transfers are expected to be restricted mainly to an amount reflecting the support of emigrants' families in Somalia. Somali workers abroad are estimated to total about 150,000, and one third of them are engaged in full-time employment; the total amount of remittances is projected at US\$50 million.

^{2/} For a list of essential imports, see footnote 1 on page 4.

authorities have reaffirmed that they regard the unification of the rates as an important objective of the current program and remain fully committed to its implementation.

Disbursed external debt at the end of 1981 is estimated to have amounted to US\$716 million, most of which is on concessional terms. However, the debt service ratio has been increasing rapidly, rising from 5 per cent of export receipts in 1980 to 18 per cent in 1981, and is projected to reach 20 per cent in 1982. ^{1/} The authorities will maintain very cautious policies on debt contracts and will limit new external debt contracts with maturities of 1-12 years to no more than US\$25 million during the program period through June 30, 1982. The authorities have already sharply reduced the outstanding payments arrears and intend to further reduce such arrears to a level of no more than US\$8.5 million by the end of March 1982 and to eliminate them completely by the end of the program period.

4. Development planning

It is expected that, during 1982, the Five-Year Development Plan (1982-86) will be launched. A preliminary draft of the plan is currently being considered by the Government. The authorities have indicated that, for the first time, the plan has been elaborated within the context of an appropriate macroeconomic framework against which projects, which have undergone rigorous feasibility studies, have been assessed. The total investment effort is estimated to amount to some So. Sh. 16 billion. This compares with a target of So. Sh. 7.1 billion during the period of the previous three-year development plan. In view of the inflation rates recently recorded in Somalia and in view of the devaluation of the Somali shilling, this represents a significant scaling down of the investment effort in real terms. The intention of the Somali authorities is to set the investment target at a more realistic level, in view of the limited absorptive capacity of the economy. Based on this investment target, real GDP at market prices is expected to increase by 4.8 per cent a year. The emphasis in the plan is expected to be on the agricultural sector, to which nearly 50 per cent of investment outlays are anticipated to be allocated. The most important project, which accounts for the bulk of total investment, is the Bardhera dam project, which will significantly increase the acreage under cultivation.

The authorities intend to expand the role of the private sector in the course of the new Five-Year Development Plan. In this connection, the Government is considering the possibility of entering into joint ventures

^{1/} No reliable data beyond 1982 are available, since the Central Bank of Somalia has not completed consolidating all external debt service by the various ministries.

with private and foreign firms in existing public enterprises and in the setting up of new semipublic enterprises. Further, the Somali Government continues to review the position of public enterprises with a view to keeping only viable enterprises in operation, although in determining the viability of certain enterprises the social functions that they perform will also be taken into account.

Although agricultural production has traditionally been in private hands, government intervention, in the form of fixing producer prices and marketing, has been important. The Government is determined to place greater reliance in price determination on the market mechanism. Accordingly, in April 1981 it abolished the Livestock Development Agency (LDA), the only official agency involved in livestock exports, and is envisaging the transformation of the role of the Agricultural Development Corporation (ADC) in the cereals market from that of a monopsonist to a market regulator. In situations of oversupply, the ADC would assume the role of a buyer of last resort and purchase the farmers' crops at the official minimum guaranteed price. In time of food shortages, the ADC would sell its stocks, thereby reducing pressure on prices. The authorities are of the view that such a measure would make the marketing structure for cereals more flexible and provide appropriate incentives to farmers without sacrificing consumer interests.

In the energy field the Somali authorities intend to continue appropriate conservation policies through a realistic pricing policy. Between 1976 and 1981 gasoline prices increased more than fivefold. In 1981, in particular, gasoline prices were increased on two occasions. At the beginning of 1981 gasoline prices were increased by approximately one third to So. Sh. 14.95/gallon, and, in the framework of the stabilization program, the price was further raised by some 150 per cent to So. Sh. 37.85/gallon in August. Although the oil refinery remained closed during the whole of 1981, due to the disruption of crude oil supplies from Iraq, it is anticipated that it will resume production early in 1982.

5. Performance criteria

The program includes as performance criteria: (1) quarterly ceilings on net domestic credit, with quarterly subceilings on net credit to the Government; (2) quarterly ceilings on gross losses arising from foreign exchange transactions in the appreciated exchange market; (3) quarterly ceilings on external payments arrears; and (4) a ceiling on external debt contracted or guaranteed by the Government with maturities of 1-12 years. These quantitative performance criteria are shown in Table 4. The performance criteria include the standard provision relating to multiple currency practices, bilateral payments arrangements, and restrictions on payments and transfers for current international transactions and on imports for balance of payments reasons.

V. Staff Appraisal and Proposed Decision

Against a background of sluggish economic growth and mounting domestic and external financial imbalances, in mid-1981 the Somali authorities launched a major adjustment effort supported by the current one-year stand-by arrangement. Economic performance in 1981 was considerably better than originally envisaged, due to the determination with which the authorities implemented the program as well as to the generally favorable weather conditions. The financial policies pursued resulted in a reduction in real aggregate demand, while a record agricultural harvest contributed to an improvement in supply conditions. Consequently, the rate of inflation dropped sharply, particularly in the second half of the year. Further, the current account deficit and the overall balance of payments deficits were substantially narrowed in 1981. External payments arrears were reduced, mainly through rescheduling.

During 1981 the Somali authorities tightened sharply their financial policies, curtailing investment significantly. The budgetary deficit was nearly halved, reflecting the effect of the devaluation on import duties and the progress made in strengthening tax collection procedures, while the growth in expenditures was contained through the institution of austerity measures, the freeze on wages after the January adjustment, and the exercise of strict expenditure control through a newly instituted reporting system. With the improved budgetary position, the monetary authorities were able to reduce the rate of growth of domestic credit by about one half during 1981. Within the context of monetary policy, the authorities revised upward the interest rate structure and authorized the opening of foreign exchange accounts designed to attract deposits of Somali emigrants.

The financial policies were reinforced by the measures taken on the supply side. In particular, the exchange rate action has contributed to a reduction in cost-price distortions and is an important element conducive, over the medium term, to the promotion of the growth of import-substituting and export-oriented activities. In this connection, the increase in producer prices for a number of agricultural products enhanced considerably the financial incentives to the agricultural sector. Further, the financial incentives to livestock exporters, who were already benefiting in part from the parallel exchange rate, were also improved, notwithstanding the 25 per cent ad valorem tax imposed on livestock exports. These measures provided the economic conditions for discontinuing the franco valuta system; the effective termination of the inflow of franco valuta imports toward the end of 1981 can be expected to lead to a rechanneling of foreign exchange through the banking system and to give the authorities greater control over the consumption-investment mix of imports. In the context of supply-oriented policies, the establishment of more realistic cost-price relations is anticipated to contribute to an improvement in the financial performance

of some public enterprises, although a number of them continue to suffer from technical and managerial problems. In this regard, the determination of the authorities to close down public enterprises considered to be not viable was reflected in the closure of three such enterprises in 1981.

The authorities are aware that the improvement in the economic situation that took place in 1981 was due in part to the unusually good weather conditions, and are continuing to pursue their adjustment efforts during 1982. On the fiscal side, they intend to reduce the level of expenditures in nominal terms below the annual level of the second half of 1981 while taking measures to increase revenues. It is expected that, as a result, the budgetary deficit will be reduced by one third during 1982. Regarding monetary policy, the objective of the authorities is to reduce the rate of growth of domestic liquidity to about one half of the growth rate recorded in 1981. This is to be achieved, in part, through a containment in the growth of domestic credit, primarily by a severe reduction in the growth of net credit to the government sector. However, in view of the high inflation rates recorded in recent years, which have led to a significant reduction in the real levels of credit to the private sector, the authorities plan to allow for an increase in the growth of private sector credit during 1982, to encourage an expansion in private sector activity and enhance the growth potential of the economy. The increase in imports related to investment and the return to more normal weather conditions are expected to result in a widening of the current account and balance of payments deficits in 1982.

Although the progress toward the re-establishment of domestic and external financial balance has been aided by the introduction of the dual exchange rate system, the authorities view this as a transitory measure and remain fully committed to the program objective of unifying the exchange rates. Accordingly, the staff recommends approval under Article VIII, and recognition under the stand-by arrangement, of the modifications introduced in the coverage of the dual exchange rate system, and of the further adaptation of the system envisaged in the program, until June 30, 1982.

The Somali authorities are aware that further adjustment measures are necessary in order to achieve a viable and sustainable balance of payments position over the medium term. They intend to undertake such measures within the context of a stabilization program, which they hope will be supported by a new arrangement from the Fund following the expiration of the current arrangement. The staff is impressed by the determination with which the authorities have followed their adjustment efforts. In the opinion of the staff, the objectives and policies for the first half of 1982, described in the annexed letter, represent a continuation of policies enunciated in the original program and testify to the perseverance of the authorities in implementing the program. The staff feels that these efforts deserve the continuing support of the Fund. Accordingly, the following draft decision is proposed for adoption by the Executive Board:

1. Somalia has consulted the Fund in accordance with paragraph 4(c) of the stand-by arrangement for Somalia (EBS/81/146, Supplement 1, July 16, 1981) in order to establish performance criteria subject to which purchases may be made by Somalia during the remaining period of the arrangement.

2. The letter from the Minister of Finance and the Governor, Central Bank of Somalia, of December 9, 1981, as amended, shall be annexed to the stand-by arrangement for Somalia, and the letter of May 13, 1981, attached to the stand-by arrangement, shall be read as modified and supplemented by the annexed letter.

3. Accordingly, paragraphs 4(a), (b), and (d)(ii) of the stand-by arrangement shall be amended to read:

"(a) during any period in which the data at the end of the immediately preceding performance period indicate that:

(i) the limit on total net domestic credit of the banking system or the limit on net credit to the Government described in paragraph 16 of the annexed letter are not observed; or

(ii) the limit on external payments arrears described in paragraph 21 of the annexed letter is not observed; or

(b) (i) if Somalia fails to observe the limits on contracting of new public and publicly guaranteed external debt described in paragraph 21 of the annexed letter; or

(ii) if the gross loss to the Central Bank of Somalia, resulting from the sale of foreign exchange for imports in the first market, exceeds the limits in paragraph 16 of the annexed letter; or

(d) (ii) introduces multiple currency practices, or modifies the multiple currency practice described in paragraphs 3 and 18 of the annexed letter, other than the elimination of the dual exchange system, or"

4. The Fund grants approval until June 30, 1982 for the modifications of Somalia's multiple currency practice as described in paragraphs 3 and 18 of the letter annexed to the stand-by arrangement for Somalia.

Table I. Somalia: Central Government Budgetary Operations, 1980-82 1/
(In millions of Somali shillings)

	1980 Year Preliminary actuals	1981				1982				Program period (1981/82) 8/ Projection	
		First half		Second half		Projections		Projections			
		Original projection	Preliminary actual	Original projection	Revised estimate	Original projection	Revised estimate	First half	Second half		Year
Total receipts	1,884	1,220	870	1,825	1,843	3,045	2,713	1,686	1,834	3,520	3,529
Total revenue	1,421	1,045	841	1,475	1,638	2,520	2,479	1,543	1,628	3,171	3,181
Tax revenue	(1,193) 2/	(925) 2/	(753)	(1,345) 2/	(1,494)	(2,270)	(2,247)	(1,352)	(1,437)	(2,789)	(2,846)
Nontax revenue	(229)	(120)	(88)	(130)	(144)	(250)	(232)	(191)	(191)	(382)	(335)
Transfers from local governments	--	--	18	--	79	--	97	80	80	160	159
Grants 3/	463	175	11	350	126	525	137	63	126	189	189
Total expenditure 4/	3,191	1,790	1,309	2,460	2,138	4,250	3,447	1,950	2,100	4,050	4,088
Ordinary	1,618	1,030	1,280 5/	1,370	...	2,400	...	...	...	...	...
Budgetary	201	140	...	210	...	350	...	...	...	...	...
development	1,372	620	29	880	...	1,500	277	...	...	...	...
Other 6/											
Overall deficit	-1,307	-570	-439	-635	-295	-1,205	-734	-264	-266	-530	-559
Financing	1,307	570	439	635	295	1,205	734	264	266	530	559
Foreign (net) 7/	542	300	38	550	323	850	361	118	189	307	441
Domestic	765	270	401	85	-28	355	373	146	77	223	118
Banking system	(671)	(270)	(375)	(85)	(-28)	(355)	(347)	(146)	(77)	(223)	(118)
Cash balances	(93)	(--)	(26)	(--)	(--)	(--)	(26)	(--)	(--)	(--)	(--)

Sources: Data provided by the Somali authorities; and staff estimates.

1/ On cash basis.

2/ Includes transfers from local governments.

3/ From balance of payments data. Excludes grants in kind.

4/ Net of amortization.

5/ Includes development expenditure.

6/ Residual items including other foreign-financed capital expenditure, other extrabudgetary expenditure, and net lending to public enterprises.

7/ Based mainly on balance of payments data.

8/ Based on revised estimates for second half of 1981.

Table II. Somalia. Factors Affecting Domestic Liquidity, 1980-82
(In millions of Somali shillings and in per cent; end of period)

	1980		1981		1982	
	Dec.		June		June	
	Actual	Estimated	Actual	Projected	Actual	Dec. Projections
(In millions of Somali shillings)						
Net foreign assets	144.8	-403.0	105.0	-970.0 1/	82.8 1/	-396.9 1/ -469.9 1/
Net domestic assets	3,236.3	3,633.0	3,935.2	4,823.0	4,080.2	4,709.6 5,180.6
Net domestic credit	3,879.5	4,273.0	4,591.5	4,550.0	4,539.3	5,096.0 5,567.0
Government (net)	1,902.4	2,150.0	2,276.8	2,257.0	2,249.3	2,395.0 2,472.0
Private 2/	1,977.2	2,123.0	2,314.7	2,293.0	2,290.0	2,701.0 3,095.0
Other items (net)	643.2	640.0	656.3	-273.0 1/	459.1 1/	386.4 1/ 386.4 1/
Of which: dual exchange rate effect	--	--	--	-512.0	95.3	59.3 59.3
Domestic liquidity	3,381.1	3,230.0	4,040.1	3,853.0	4,163.0	4,312.7 4,710.7
(Percentage changes from end of previous year)						
Net foreign assets	-54.5	-378.3	-27.5	-769.9 3/	-42.8 (-21.1) 4/	-579.3 (-478.0) 4/ -667.5
Net domestic assets	29.7	12.3	21.6	49.0	26.1	15.4 27.0
Net domestic credit	31.2	10.1	18.4	(32.8) 3/	(3.7) 4/	(19.7) 4/ 22.6
Government (net)	54.5	13.0	19.7	(6.5) 3/	(-1.1) 4/	(11.0) 4/ 9.9
Private 2/	14.6	7.4	17.1	(5.0) 3/	(-1.2) 4/	(5.2) 4/ 35.2
Other items (net)	39.2	-0.5	2.0	(8.0) 3/	(-1.1) 4/	(16.7) 4/ -15.8
Domestic liquidity	20.2	-4.5	19.5	-142.4 (-142.7) 3/	-28.6 (-30.0) 4/	(-15.8) (-41.1) 4/

Sources: IMF, International Financial Statistics; data provided by the Central Bank of Somalia; and staff estimates.

- 1/ Includes valuation adjustments for revaluation of net foreign assets on June 30, 1981 and dual exchange rates.
2/ Public enterprises and private sector.
3/ Percentage change from estimated June 1981.
4/ Percentage change from actual June 1981.

Table III. Somalia: Monetary Survey, 1980-82

(In millions of Somali shillings and in per cent; end of period)

	1981				1982				
	March	June	Sept.	Dec.	March	June	Sept.	Dec.	
	Actual				Projections				
(In millions of Somali shillings)									
Net foreign assets	144.8	143.7	105.0	434.4 1/	82.8 1/	-157.1 1/	-396.9 1/	-433.4 1/	-469.9 1/
Domestic credit	3,879.5	4,183.8	4,591.5	4,373.6	4,539.3	4,850.0	5,096.0	5,276.0	5,567.0
Government (net)	1,902.4	2,023.0	2,276.8	2,196.0	2,249.3	2,337.0	2,395.0	2,425.0	2,472.0
Private 2/	1,977.2	2,160.8	2,314.7	2,177.6	2,290.0	2,513.0	2,701.0	2,851.0	3,095.0
Of which: public enterprises	1,551.1	1,632.0	1,722.4	1,631.6	1,715.6				
Broad money	3,381.1	3,726.1	4,040.1	4,278.3	4,163.0	4,290.5	4,312.7	4,456.2	4,710.7
Other items (net)	643.2	601.3	656.3	529.7	459.1	402.4	386.4	386.4	386.4
Revaluation of net foreign assets 3/	--	--	--	105.0	105.0	105.0	105.0	105.0	105.0
Dual exchange rate effect 4/	--	--	--	155.2	95.3	75.3	59.3	59.3	59.3
Other items (net)	643.2	601.3	656.3	269.5	258.8	222.1	222.1	222.1	222.1
(Percentage changes from end of previous year)									
Net foreign assets	-54.5	-0.8	-27.5	200.0	-42.8	-289.7	-579.3	-623.4	-667.5
Domestic credit	31.2	7.8	18.4	12.7	17.0	6.8	12.3	16.2	22.6
Government (net)	54.5	6.3	19.7	15.4	18.2	3.9	6.5	7.8	9.9
Private 2/	14.6	9.3	17.1	10.1	15.8	9.7	17.9	24.5	35.2
Broad money	20.2	10.2	19.5	26.5	23.1	3.1	3.6	7.0	13.2
Other items (net)	39.2	-6.5	2.0	-17.7	-28.6	-12.4	-15.8	-15.8	-15.8

Sources: IMF, International Financial Statistics; data provided by the Central Bank of Somalia; and staff estimates.

1/ Includes valuation adjustments.

2/ Public enterprises and private sector.

3/ Due to the revaluation of net foreign assets on June 30, 1981.

4/ Based on transactions in the first exchange rate market amounting to So. Sh. 187.0 million in receipts and So. Sh. 31.8 million in payments at end-September 1981, So. Sh. 296.4 million in receipts and So. Sh. 201.1 million in payments at end-December 1981, So. Sh. 456.4 million in receipts and So. Sh. 381.1 million in payments at end-March 1982, and So. Sh. 610.4 million in receipts and So. Sh. 551.1 million in payments at end-June 1982.

Table IV. Somalia: Balance of Payments Projections, 1981-82

(In millions of U.S. dollars)

	1980 Actual	1981				1982				Program period (1981/82) Projection	
		First half		Second half		Year		Projections			
		Original proj.	Prel. actual	Original proj.	Rev. est.	Original proj.	Rev. est.	First half	Second half		Year
Goods and services	-203.3	-136.7	-52.6	-108.1	-68.5	-244.8	-121.1	-78.1	-55.8	-133.9	-146.6
Exports, f.o.b.	137.0	68.9	50.1	103.3	95.8	172.2	145.9	67.9	108.2	176.1	163.7
Livestock	108.9	56.0	36.4	84.0	78.8	140.0	115.2	46.8	87.0	133.8	125.6
Bananas	7.8	4.2	2.0	6.2	5.2	10.4	7.2	7.9	8.0	15.9	13.1
Others	20.3	8.7	11.7	13.1	11.8	21.8	23.5	13.2	13.2	26.4	25.0
Imports, c.i.f.	-333.5	-197.6	-106.8	-203.5	-154.3	-401.1	-261.1	-140.0	-160.0	-300.0	-294.3
Franco valuta	-54.9	-30.0	-40.0	--	-20.0	-30.0	-60.0	--	--	--	-20.0
Others 1/	-278.6	-167.6	-66.8	-203.5	-134.3	-371.1	-201.1	-140.0	-160.0	-300.0	-274.3
Trade balance	-196.5	-128.7	-56.7	-100.2	-58.5	-228.9	-115.2	-72.1	-51.8	-123.9	-130.6
Services (net)	-6.8	-8.0	4.1	-7.9	-10.0	-15.9	-5.9	-6.0	-4.0	-10.0	-16.0
Transfers (net)	129.7	30.0	41.7	75.0	32.0	105.0	73.7	30.0	35.0	65.0	62.0
Private	56.2	30.0	40.0	25.0	22.0	55.0	62.0	25.0	25.0	50.0	47.0
Official 2/	73.5	--	1.7	50.0	10.0	50.0	11.7	5.0	10.0	15.0	15.0
Current account balance	-73.6	-106.7	-10.9	-33.1	-36.5	-139.8	-47.4	-48.1	-20.8	-68.9	-84.6
Capital account balance	26.4	19.8	6.0	19.9	26.4	39.7	32.4	10.0	15.0	25.0	36.4
Private	-0.1	--	--	--	--	--	--	--	--	--	--
Official 3/	26.5	19.8	6.0	19.9	26.4	39.7	32.4	10.0	15.0	25.0	36.4
Errors and omissions	19.5	--	-1.4	--	--	--	-1.4	--	--	--	--
Overall balance	-27.7	-86.9	-6.3	-13.2	-10.1	-100.1	-16.4	-38.1	-5.8	-43.9	-48.2

Sources: Data provided by the Somali authorities; and staff estimates.

1/ Excluding loans and grants in kind.

2/ Excluding grants in kind.

3/ Excluding loans in kind.

Table V. Somalia: Producer Price for Major Crops, 1975-81
(In Somali shillings per quintal)

	1975	1976	1977	1978	1979	1980	1981 1/
Bananas							
Nominal producer price	51.0	51.0	56.0	56.0	56.0	66.0	170.0
"Real" price index 2/	51.0	44.7	44.4	40.4	32.6	24.1	42.7
Maize							
Nominal producer price	55.0	60.0	75.0	75.0	75.0	120.0	180.0
"Real" price index 2/	55.0	52.6	59.5	54.1	43.7	43.8	45.2
Sorghum							
Nominal producer price	55.0	60.0	75.0	75.0	75.0	120.0	160.0
"Real" price index 2/	55.0	52.6	59.5	54.1	43.7	43.8	40.2
Rice							
Nominal producer price	350.0	350.0	350.0	350.0	350.0	350.0	3/
"Real" price index 2/	350.0	307.0	277.6	252.3	203.7	127.8	
Cotton							
Nominal producer price	200.0	240.0	260.0	260.0	260.0	300.0	350.0
"Real" price index 2/	200.0	210.5	206.2	187.5	151.3	109.6	87.9
Sesame							
Nominal producer price	200.0	200.0	240.0	240.0	240.0	300.0	450.0
"Real" price index 2/	200.0	175.4	190.3	173.0	139.7	109.6	113.0
Memorandum item:							
Average consumer price index	100.0	114.0	126.1	138.7	171.8	273.8	398.1 4/

Source: Data provided by the National Banana Board and the Agricultural Development Corporation.

1/ The banana producer price was increased to So.Sh.82/quintal on April 19 and to So.Sh.170/quintal on June 30. All other producer price increases occurred on April 19.

2/ Deflated by the Mogadiscio Consumer Price Index.

3/ This price series refers to milled rice. In 1981 the Government discontinued purchases of milled rice. The prices for unmilled short- and long-grain rice were set at So.Sh.320 and So.Sh.280/quintal, respectively.

4/ Estimate.

Table VI. Somalia: Principal Assumptions for Projection of
Fiscal Aggregates, 1981-82

1. Projection for 1981

First three quarters of 1981: All data are based on preliminary actuals.

Fourth quarter of 1981:

Revenue: Revenue is projected to decrease 15.5 per cent from the third quarter. Of this, 82 per cent is due to a temporary reduction in the volume and a change in the composition of imports (to lower duty items) associated with the closure of the franco valuta market. The remainder is due to the seasonal pattern of collection of taxes from public enterprises.

Expenditure: Expenditure is projected to decrease 2 per cent from the third quarter. This reflects increased expenditure control as adjustments to devaluation are effected and as on-going expenditure control measures are improved.

2. Projection for 1982

Revenue:

Income tax (4 per cent of total revenue): Income tax is projected to increase 2 per cent over the 1981 base. This reflects a combination of a progressive tax and a weak collection system.

Property and stamp taxes (8 per cent of total revenue): Revenue from property and stamp taxes is projected by the Somali authorities to increase 10 per cent over the 1981 base. This reflects the ad valorem component of the tax base.

Taxes on goods and services (20 per cent of total revenue): Revenue is projected by the Somali authorities to increase 126 per cent over the 1981 base. This increase is largely due to the expected increase in excises on sugar as the sugar refineries approach full capacity. Because of spring flood conditions and mechanical problems with the recently completed Juba refinery, production in 1981 was estimated at 20 per cent of capacity.

Import taxes (52 per cent of total revenue): The estimation base is the first half of 1981 and the devaluation effect is 100 per cent on the base. For the first half, the inflation effect is 10 per cent on the base. For the second half, the inflation effect is 15 per cent on the base and the effect of improved administration is 5 per cent on the base.

Export tax (4 per cent of total revenue): The volume and composition base is 1981, and the minimum export prices are equal to their pre-devaluation values in foreign exchange terms. The tax rate is 25 per cent.

Nontax revenue (12 per cent of total revenue): The projected revenue is an 65 per cent increase over 1981. This is 28 per cent below Somali prebudget estimates. It reflects the earning potential of the recently completed Juba sugar refinery, the effect of measures now under way to improve the efficiency and the taxation of public enterprises, and the effect of devaluation on prices for import-substituting industries.

Expenditure: The base is the first half of 1981. The import content of the budget is 44 per cent and the annual inflation rate for imports is 10 per cent. Economies are to be effected to compensate for the pass-through devaluation effect on domestic expenditures.

Table VII. Somalia: Principal Assumptions for Balance of Payments Projections, 1981-82

1. Projection for 1981
First half of 1981

All data are based on preliminary actuals.

Second half of 1981

Exports, f.o.b: Livestock exports are based on monthly actuals up to September and on last year's actual for the last quarter, assuming a 20 per cent increase in value due to some elimination of underinvoicing activities. Banana exports are based on shipping schedules of the Banana Board.

Imports, c.i.f: Franco valuta imports are based on information provided by the authorities. Official imports are based on a 100 per cent increase from the first half level but a substantial decline (28 per cent) from the last year's level, taking account of the performance in the first half (50 per cent decline from the last year's level).

Private transfers: Remittances by Somali workers abroad through the banking system, and the counter-entry of the franco valuta imports.

Official transfers and capital: Data provided by the Central Bank.

2. Projection for 1982

Exports, f.o.b: Livestock exports are expected to increase in volume by 1 per cent and in price by 15 per cent, due to further elimination of underinvoicing activities. Based on previous cyclical pattern, it is assumed that 35 per cent of exports take place in the first half and 65 per cent in the second half. Based on shipping schedules, banana exports are expected to increase in volume from 34,000 tons in 1981 to 70,000 tons in 1982 and in price by 7.2 per cent.

Imports, c.i.f: Franco valuta imports are totally discontinued. Official imports are expected to cover a certain level of commodities imported through the franco valuta system previously, and to maintain a growing tendency from the last half. Annually total imports are expected to increase in price by 6 per cent and in volume by 9 per cent.

Private transfers: Assumed constant remittances to families in Somalia by 150,000 workers abroad, of which one third are engaged in full-time employment and remit an estimated US\$100 per month.

Official transfers and capital: Data provided by the Central Bank.

SOMALIA - Relations with the Fund
(As of January 31, 1982)

Date of membership:	August 31, 1962
Quota:	SDR 34.5 million
Fund holdings of currency as per cent of quota	SDR 63.8 million, or 184.9 per cent of quota
Credit tranches	SDR 16.0 million, or 46.5 per cent of quota
Enlarged access	SDR 13.2 million, or 38.4 per cent of quota
SDR position:	SDR 3.7 million, equivalent to 27.0 per cent of net cumulative allocation of SDR 13.7 million
Trust Fund loans outstanding:	
Total	SDR 10.7 million
First period	Nil
Second period	SDR 10.7 million
Direct distribution of profit from gold sales:	US\$3.02 million
Gold distribution:	16,261 fine ounces of gold
Intervention currency and the rate:	U.S. dollar; So. Sh. 12.5900 = US\$1 for all transactions except essential imports, receipts of foreign embassies and certain companies, and transactions through nonresident accounts in Somali shillings, for which So. Sh. 6.2950 = US\$1 applies.
<u>Staff visits and other contacts:</u>	
Technical assistance (exchange rate study mission)	January 1980
Technical assistance (Fiscal Affairs--revenue study mission)	March 1980
Stand-By review mission	June 1980
Technical assistance (Bureau of Statistics--compilation of government finance statistics mission)	September 1980

SOMALIA - Relations with the Fund (concluded)

Last Article IV consultation and
use of Fund resources mission

May 1981; Board discussion of staff
reports (SM/81/147, SM/81/155, and
EBS/81/146) took place on July 15,
1981.

Other technical assistance

Since March 1980 a CBD panel expert has been serving at the Central Bank as advisor on bank supervision and foreign exchange budgeting. At the end of March 1981 an advisor from the FAD panel began assisting the Accounting Department of the Ministry of Finance.

CONFIDENTIAL

Mogadishu
December 9, 1981

As amended on
March 9, 1982 in
Washington, D.C.

Somali Democratic Republic
Ministry of Finance
Office of the Minister

Mr. J. de Larosière
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431
U.S.A.

Dear Mr. de Larosière:

1. On July 15, 1981, the Executive Board approved for Somalia a stand-by arrangement equivalent to SDR 43.13 million (125 per cent of Somalia's quota). The arrangement was in support of our financial and economic program to stimulate domestic production, reduce excess demand pressure, and achieve a sustainable external sector position over the medium term. As you will recall, we expected at the time of the adoption of the program that the full effect of the policies would take time to materialize due to the structural and financial imbalances in the economy. We are, however, pleased to inform you that measures in the program have already contributed in the latter half of 1981 to some increase in production, a decline in inflationary pressures, and an improvement in the current account and overall balance of payments positions. During the second half of the program period, we shall continue to follow policies in the context of our current stand-by arrangement that are consistent with the objectives of our financial and economic program.

Review of Developments Under the Program

2. The financial program supported by the Fund contained measures affecting both supply and demand conditions. On the supply side, the key element was the establishment of a dual exchange rate arrangement under which all foreign exchange transactions other than for specified essential imports would take place at an exchange rate (So. Sh. 12.59 = US\$1) representing a 50 per cent devaluation of the official rate in foreign currency terms; specified essential commodities would continue to be imported at the previous rate (So. Sh. 6.295 = US\$1). Concomitantly, the Government was to cease issuing foreign exchange licenses for own-foreign exchange imports (franco valuta imports). In addition, the program involved an

upward revision in producer prices, a review of the position of the public enterprises, and a strengthening of the development planning process. On the demand side, the program provided for a tightening of fiscal and monetary policies, including a substantial increase in interest rates. All the measures that were to be taken on June 30, 1981, with regard to the exchange rate, the ad valorem export tax on livestock, the doubling in the producer price of bananas, the increase in interest rates, and the discontinuation of granting licenses for franco valuta imports were enacted, although, as explained below, some difficulties arose in connection with the implementation of a few of the measures. Further, all the performance criteria for the first quarter ending September 1981 were met, and we expect to meet the performance criteria for the second quarter ending December 1981.

3. In accordance with our letter of intent, the first foreign exchange market, which would retain the original exchange rate of So. Sh. 6.295 = US\$1, was to cover transactions relating to imports of specified essential goods only. These were certain foodstuffs, 1/ medicines and chemicals, manufacturing raw materials, spare parts, and agricultural inputs. However, while implementing this measure, it was decided to include in this market the receipts of foreign missions accredited to Somalia and of certain foreign companies and the transactions through nonresident accounts in Somali shillings in order to limit the losses to the Central Bank arising from such imports and to avoid a decline in foreign exchange receipts from this source. Consequently, in view of the generally favorable supply conditions in the country, which reduced the need for specified essential imports, and in view of the level of receipts covered by the first market, we estimate that there was a net surplus in the transactions of this market amounting to about US\$15 million during the second half of 1981, resulting in net profits to the Central Bank equivalent to about So. Sh. 95 million.

4. The discontinuation of granting of licenses for franco valuta imports met with considerable resistance. The Government initially authorized the entry of such imports for merchants holding licenses granted prior to June 30, 1981, until August 14, 1981. However, ships carrying own-foreign exchange imports continued to arrive at the ports of Somalia thereafter. Accordingly, effective September 30, 1981, the Government imposed a penalty resulting in doubling of import taxes on all such imports and announced that all such imports would be confiscated after November 15, 1981. This policy of confiscation was effectively implemented, and all franco valuta imports have ceased. The Central Bank is granting letters of credit to ensure that transactions concerning goods previously imported through the franco valuta system can now be effected through the banking system.

1/ These consisted of rice, sugar, pasta, flour, tea, coffee, edible oil, dates, maize, millet, and wheat.

5. Reflecting in part the exchange rate action, the change in producer prices, the relatively favorable weather conditions, and the restrained financial policies pursued, the balance of payments developments during 1981 have been considerably better than originally projected. While a deficit of about US\$100 million had been projected for 1981, we now estimate that the balance of payments position will record a deficit of about US\$16 million. On the basis of our estimates, export receipts increased by about 7 per cent, due to some improvement in receipts from the livestock sector and a surge in banana exports during the second half of the year. Nevertheless, export receipts were lower than projected, partly due to the continuation of some underinvoicing practices. Imports were substantially lower than in 1980 and than the original projections for 1981 indicated due to two main factors. First, there were favorable weather conditions in the country that reduced the need for imports of essential foodstuffs. Second, the austere financial policy pursued, which included a curtailment in the investment efforts, resulted in a sharp drop in capital goods imports. As a result, the trade balance deficit, originally projected at about US\$230 million, is now estimated at about US\$115 million. Although official transfers were lower than originally projected, private transfers exceeded projections. The current account deficit for 1981 is now estimated at US\$47 million as compared with an original projection of US\$140 million. Because of the lower current account deficit, it was possible to reduce net foreign borrowing to a level lower than originally envisaged.

6. During the second half of 1981 the Somali Government has not contracted any new external debt with a maturity of between 1 and 12 years. Further, in accordance with the stated intention of the Government in our letter of intent of May 13, 1981, we have reduced external debt arrears through renegotiation or repayments from US\$71.3 million at end-June 1981 to US\$16.9 million at end-November 1981.

7. The extremely austere fiscal policy pursued by the Somali Government during 1981 resulted in a near halving of the budgetary deficit, from So. Sh. 1,307 million in 1980 to an estimated So. Sh. 734 million in 1981. This compares favorably with the original projected deficit of So. Sh. 1,205 million for 1981. Expenditures are estimated to be 8 per cent higher than the 1980 level and amounted to an estimated four fifths of the originally projected 1981 level. Economies were effected through improvements in expenditure control, a freeze in wages after the January increase, limitations on new employment, strict ceilings on administrative expenditures, and reduced investment expenditures. The curtailment in expenditures from the originally projected level more than compensated for the shortfall in revenues that took place. At about So. Sh. 2.7 billion, revenues are 44 per cent higher than in 1980, albeit somewhat below the projection of So. Sh. 3.0 billion originally projected. This shortfall is due to a number of factors. First, there was considerable resistance on the part

of livestock exporters to the 25 per cent ad valorem tax enacted on June 30, 1981 on livestock exports in conjunction with the exchange rate measures. Lengthy negotiations have taken place with representatives of livestock exporters in this connection. Although they have now accepted the principle of the tax, there are discussions under way to determine the exact export, f.o.b., price on which the tax has to be levied. Pending the settlement of the issue regarding the f.o.b. export prices, livestock exporters have been required to pay the tax on the basis of the revised minimum export price in the valuation list. Second, transfers from public enterprises have been substantially lower than projected. A major part of the shortfall in such transfers is accounted for by floods in April that affected adversely the output of the two sugar factories; these operated at less than 20 per cent of capacity during 1981. Third, the lower domestic production of sugar also affected adversely excise tax revenues.

8. The deficit of the budget, which was reduced from 41 per cent of total expenditures in 1980 to 21 per cent in 1981, was financed almost equally by net foreign borrowing and by domestic credit from the banking system. The use of domestic bank credit during 1981 was about half that of 1980.

9. In part due to the more restrictive fiscal stance, the Central Bank has been able to pursue a much tighter credit policy during 1981. The expansion in domestic credit in 1981 is now estimated at about 17 per cent, as projected in the program, as compared with 31 per cent in 1980. As credit to the Government grew by about 18 per cent in 1981 as compared with 55 per cent in 1980, it was possible for the Central Bank to allow for an increase in credit to the private sector (including public enterprises) by 16 per cent, implying somewhat of a reduction in the crowding out of private sector credit by the government sector. Primarily due to the fact that the balance of payments is estimated to have recorded a smaller deficit in 1981 than originally projected, domestic liquidity is estimated to have grown by about 23 per cent as compared with an original projection of 14 per cent.

10. To mobilize savings and improve credit allocation, we increased interest rates on June 30, 1981 for savings and time deposits to a range of 6-9 per cent from 4-7 per cent; the central bank discount rate and the Treasury bill rate were increased to 6 per cent from 4 per cent; commercial bank lending rates were raised to 10 per cent from a range of 6-9.5 per cent; and the Development Bank's medium- and long-term lending rates were increased to a range of 10-14 per cent from 5.5-7.5 per cent. Further, we have also introduced nonresident accounts denominated in U.S. dollars to attract the savings of Somali workers abroad. Interest rates on these accounts are set at rates competitive with those prevailing on the international market.

11. Through July 1981 the consumer price index increased rapidly but subsequently declined during the rest of the year. The rate of inflation for 1981 as a whole is now estimated at about 46 per cent compared with about 60 per cent in 1980. The easing of inflationary pressures during the second half of the year reflected the financial policies pursued, the closure of the franco valuta market, and the favorable supply condition.

Prospects and Policies for 1982

12. During 1982, including the first half of the year (corresponding to the second half of the program period), we intend to continue to pursue with determination our adjustment efforts in order to consolidate and build upon the progress made in 1981. Regarding fiscal policy, we intend to take measures both on the revenue and expenditure sides to reduce the budgetary deficit by about one third in nominal terms. Regarding monetary policy, we shall continue to pursue a tight monetary policy aimed at reducing the growth rate of domestic liquidity. As the Five-Year Development Plan (1982-86) is expected to be launched in 1982, some resumption of imports associated with the investment program can be expected to take place, with the result that, notwithstanding a considerable improvement in the export performance, the trade balance deficit will widen and an overall balance of payments deficit of about US\$44 million is expected to emerge. With the restrained financial stance adopted and generally improved supply conditions, inflationary pressures can be expected to moderate further in 1982.

The broad outline of our policies for 1982, including the second half of the program period, is as follows:

13. Fiscal policy: During 1982 we intend to reduce the budgetary deficit to about So. Sh. 530 million, or from about 21 per cent of total expenditures in 1981 to about 13 per cent in 1982. We expect revenues to increase by about 30 per cent during 1982, reflecting in part the effects of the rise in nominal income resulting from the inflation rate recorded in 1981 as well as from the taking hold of a number of revenue measures. In particular, the Government expects that, upon reaching an agreement with the livestock exporters, the 25 per cent ad valorem tax will start to generate additional revenues to the budget. In this connection, the Government will set up a monitoring apparatus in cooperation between the Ministry of Finance and the Central Bank to review the invoices of livestock exporters to ensure that no underinvoicing takes place. The minimum export price will, however, be kept in effect as the lower floor below which no invoices will be accepted. With the cessation of franco valuta imports, import ad valorem taxes will be levied on the basis of the letters of credit required for foreign exchange conversion. This will avoid any undervaluation that may have resulted from the previous system under which imports were taxed on the basis of a valuation list. Within the context of the 1982 budget, most specific import and export duties are being converted to an ad valorem basis. Further, the scope for exemptions on import duties some public and private enterprises currently enjoy is being narrowed.

Measures to improve tax collection are expected to be strengthened further in 1982. As indicated in our letter of intent of May 13, 1981, we have been studying the methods necessary to enact a number of the longer-term improvements in the tax system recommended in the tax report prepared by a mission from the IMF in 1980 and we expect to be able to enact some of these measures within the context of future budgets.

14. During 1982, we intend to contain the growth in government expenditures to about 17 per cent, which, given the inflation rates recorded in recent years, implies a cut in real expenditures. The increase is necessitated largely by the rise in prices and the higher domestic counterpart of foreign government expenditures. The Government does not plan to grant any cost-of-living increases to civil servants during 1982 and intends to limit the growth in the wage bill by a lower level of government hiring. Although the Government officially provides automatic employment to high school graduates applying for government positions, the number of applications has declined sharply during 1981 due to the low level of salaries. As a result, the level of government employment is expected to have declined in 1981 and we expect this to continue to be the case in 1982. We will also continue to improve the administrative mechanism for expenditure control.

15. The budgetary deficit is expected to be financed to the extent of nearly 60 per cent by foreign borrowing. The recourse to credit from the domestic banking system is expected to be limited to So. Sh. 223 million, or about 36 per cent less than in 1981.

16. Monetary policy: As indicated above, we intend to continue pursuing a tight monetary policy during 1982. Nevertheless, the improvement in the budgetary situation expected during 1982 should facilitate our efforts in providing more adequately for the credit needs of the private sector. During 1982 we intend to limit the growth in domestic credit to about 23 per cent, which, together with the projected change in net foreign assets, implies a reduction in the rate of domestic liquidity expansion to 13 per cent. For purposes of monitoring the program, net domestic credit will not exceed So. Sh. 4,850 million at end-March 1982 and So. Sh. 5,096 million at end-June 1982. Within this global ceiling, and consistent with our fiscal objectives, net bank credit to government (defined as the banking system's claim on Government, less Government deposits, plus any budgetary use of the local currency counterpart in respect of purchases from the Fund) will not exceed So. Sh. 2,337 million by end-March 1982 and So. Sh. 2,395 million by end-June 1982. Further, in order to monitor the impact of the dual exchange rate system, the gross losses resulting from the sale of foreign exchange for imports in the first market will not exceed So. Sh. 180 million by end-March 1982 and So. Sh. 350 million by end-June 1982.

17. As the interest rate structure was substantially revised upward in 1981 and as the rate of inflation subsided, particularly in the second half of 1981, the Government does not consider that there is a need for any revision in the structure at this time. However, the Government will keep under review the interest rate structure.

18. Exchange rate policy: The Somali Government views the dual exchange rate system established on June 30, 1981, as an initial step toward the establishment of a realistic unitary exchange rate. During the second half of the program period we intend to remove from the first foreign exchange market, receipts of foreign missions, certain foreign companies and transactions through nonresident accounts in Somali shillings ^{1/} and to further work toward the narrowing of the scope of this market. We consider that unification of the rates is an important objective of this program, and we remain fully committed to this objective. In this connection, we request Fund approval for the interim modification of the dual exchange rate system as described in paragraph 3 above.

19. Public enterprises: The Somali Government remains committed to improve the productivity and profitability of public enterprises and to keep only viable enterprises in operation, although, in determining the viability of certain enterprises, the social functions that they perform would also be taken into account. Our policy, as outlined in Paragraph 11 of our letter of intent of May 13, 1981, will continue in 1982. The Government is, in addition, currently considering the possibility of entering into joint ventures with private and foreign firms in certain public enterprises and in the setting up of new semipublic enterprises. In this context, the Government has decided to review its overall policy toward taxation of public enterprises.

20. Development planning: A preliminary draft of the Five-Year Development Plan (1982-86) is now ready and is being considered by the Government. For the first time, the plan has been elaborated within the context of an appropriate macroeconomic framework, against which projects, which have undergone rigorous feasibility studies, have been assessed. The plan places considerable emphasis on the development of the agricultural sector and infrastructural facilities. After the plan has been reviewed by the Somali Government, it is the intention of the Government to discuss the financial implications of the plan with the IMF.

21. External debt: Disbursed external debt at the end of 1981 is expected to amount to US\$716 million, most of which is on concessional terms. The debt service ratio rose from 5 per cent of export receipts in 1980 to 18 per cent in 1981 and is expected to reach 20 per cent in 1982. Although during 1981 we reduced substantially our external debt arrears, at end-November 1981 these amounted to about US\$16.9 million. The Somali Government is committed to totally eliminate external debt arrears through renegotiation or repayment by the end of the program period. Accordingly, arrears will be reduced to no more than US\$8.5 million by end-March 1982 and eliminated by end-June 1982. In this regard, we also intend to continue with our intention to limit new commitments on public and publicly guaranteed external debt with a maturity of 1 to 12 years to no more than US\$25 million through June 30, 1982, excluding any refinancing loans obtained through negotiations.

^{1/} Effective February 27, 1982, these measures were implemented.

22. The Somali Government believes that the policies set forth in our letter of intent of May 13, 1981 and supplemented by this letter are adequate to achieve the objectives of the program and will take any further measures that may become necessary for this purpose.

Sincerely yours,

/s/

Mohamud Jama Ahmed
Governor, Central Bank of Somalia

/s/

Abduallah Ahmed Addou
Minister of Finance