EBS/07/108
Correction 1

October 9, 2007

To: Members of the Executive Board

From: The Secretary

Subject: **Central African Republic—Staff Report for the 2007 Article IV Consultation, First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Request for Waiver of Nonobservance and Modification of Performance Criteria, and Financing Assurances Review**

The attached corrections to EBS/07/108 (9/14/07) have been provided by the staff.

Factual Errors Affecting the Presentation of Staff's Analysis or Views

Page 4, para. 2, last line: for "22.6 24 percent" read "22.6 percent"

Page 15, para. 26, line 7: for "(less than 7 percent of the population has access to electricity)"
read "(only 3 percent of the population has access to electricity)"

Page 16, Box 2, third para., line 2: for "ratio rises triples from less than 10 percent currently to above 30 percent"
read "ratio rises from less than 10 percent currently to above 30 percent"
line 3: for "The staff scenario has growth increasing moderately"
read "The staff scenario has GDP growth increasing moderately"

Questions may be referred to Mr. Kinoshita (ext. 39798) and Ms. Schumacher (ext. 39416) in AFR.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (3)

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EXECUTIVE SUMMARY

Over the past several decades political struggle and armed conflict have adversely affected domestic stability in the Central African Republic (C.A.R.), slowing growth and causing a deterioration in living standards. But a recent improvement in the political and social situation and economic policies has provided a firm basis for economic recovery. The reengagement of the international financial community has helped, but foreign aid has been unpredictable and insufficient.

Recent developments and prospects

- **At 4.1 percent, real GDP growth in 2006 reached the highest level in a decade and inflation has moderated more recently.** Private consumption and investment picked up, as did diamond and timber exports. For the first time in years, agriculture made a modest contribution to growth with the resurgence of cash crops like cotton and coffee.
- **The government's fiscal objectives for 2006 were achieved and performance was generally satisfactory in the first half of 2007.** Firm control over expenditure, especially wages and salaries, and strong tax collections stemming from tax and customs administration improvements and some tax measures, led to a domestic primary surplus of 0.4 percent of GDP last year, in line with the budget. This surplus has narrowed slightly during the first semester of 2007, partly on account of a government decision to help facilitate the recapitalization of a troubled commercial bank and delays in aid flows.
- **Progress is being made on structural reform**. Public financial management, domestic revenue mobilization, and governance is being enhanced, and the reform agenda is being broadened to improving the business environment more generally.
- **The short-term outlook is benign.** There is an upside risk if the disbursement of aid inflows is higher than programmed this year.

Policies to enhance external viability

- **Policies to raise potential growth could enhance external viability.** These policies would help reverse the prolonged decline in the country's openness to trade, enhance competitiveness, and diversify the export base. Here, consolidating macroeconomic stability and accelerating structural reform are important, with the smooth execution of the program highly dependent on financial and technical assistance from donors.
- **Clearly, a recovery of the private sector will be required to sustain high growth.** In this regard, creating a more favorable environment for investment is critical. Key private sector reforms include updating forestry and mining legislation, fully implementing OHADA business laws, and combating corruption.
- **A medium-term fiscal strategy is becoming a high priority.** Such a strategy should be rooted in fiscal sustainability so that it can provide a sound basis for dealing with the anticipated scaling up of aid flows, and possible future borrowing in the sub-regional or domestic market.

Given the generally satisfactory implementation of the PRGF arrangement through end-June 2007, the staff supports the completion of the first review and the authorities' request for waiver of three quantitative and two structural performance criteria, and modification of the end-December 2007 targets, in light of the corrective actions taken and the authorities' commitment to achieve the policy objectives supported by the arrangement.

I. Background

1. **Over the past several decades political struggle and armed conflict have adversely affected domestic stability in the C.A.R., slowing growth and causing a deterioration of living standards**. The economy has also been buffeted by exogenous shocks, such as droughts and regional instability, and a long-term decline in the terms of trade that brought trade volumes down. The C.A.R. has thus made virtually no progress on achieving the Millennium Development Goals (MDGs), and the UNDP's human development index places the C.A.R. near the bottom of all countries (172nd of 177).

2. **The formal sector has been declining for years, making it hard to mobilize domestic revenue and leading to a significant accumulation of domestic and external public debt.** At about 8 percent of GDP, the C.A.R.'s tax revenue ratio is among the lowest for developing countries. At the end of 2006, the country's public and publicly-guaranteed external debt was estimated at US$ 726 million in NPV terms, equivalent to about 350 percent of exports of goods and services and 518 percent of government revenue; domestic debt was about 22.6 ~~24~~ percent of GDP.

3. **A coup d'état in 2003 marked the end of generalized conflict and the beginning of economic and institutional recovery.** General Bozizé, the leader of the coup, later won free and fair elections in 2005. Since then, despite pockets of insecurity, the political and social situation has generally become more stable. This has allowed the government to focus on economic management—a critical element supporting recovery.

4. **Recent political and economic developments have encouraged the international financial community to reengage with the C.A.R.** The Fund provided Emergency Post-Conflict Assistance in July 2004 and January 2006 and approved a three-year PRGF arrangement in December 2006; arrears to the World Bank and the African Development Bank (AfDB) were cleared late last year. In March 2007, the Fund's Board also agreed that the country is eligible for enhanced Heavily Indebted Poor Countries (HIPC) Initiative debt relief and that it could reach the decision point when the first review of the PRGF arrangement is completed. The C.A.R. will qualify for the Multilateral Debt Relief Initiative (MDRI) once it reaches the HIPC completion point. In April 2007 the Paris Club agreed to reschedule its debt on Naples terms and to defer debt service during the program period (2007–09); the terms will improve to Cologne terms at the decision point.[1] In June 2007 a

[1] The staff understands that the authorities are making a good faith effort to reach a collaborative agreement with its other bilateral and commercial creditors; and it is expected that debt to these creditors will be rescheduled on terms at least as favorable as those granted by the Paris Club.

domestic payments arrears (accumulated during 1998–2004), and that private sector development is unlikely to take place until dilapidated infrastructure is rehabilitated. Acknowledging the difficult financial environment facing the C.A.R., staff urged the authorities to accelerate efforts to strengthen public financial management (in particular, treasury operations and cash-flow management, implementing the new budget nomenclature, and better controlling payrolls); push to reach the HIPC completion point to benefit from debt relief as soon as possible; and finalize the PRSP to ensure a firm foundation for soliciting donor assistance in the roundtable planned for late October of this year.

Tapping Financial Markets

25. **The authorities took the opportunity to clarify their intentions concerning the possibility of accessing the CEMAC financial market on commercial terms by issuing bonds, as some countries in the West African Economic and Monetary Union are doing.**[12] The authorities explained that issuing bonds could help improve debt sustainability by refinancing C.A.R. domestic bank debt on more favorable terms, and to complement donor resources to finance the country's vast investment needs. The staff acknowledged that refinancing relatively high cost commercial bank debt with this bond could improve debt sustainability, but that the amounts envisaged under the authorities' proposal went well beyond this, with adverse implications for the fiscal position. The staff and the authorities agreed to revisit this issue at a later stage, and in the meantime, the authorities indicated that they would not proceed with this proposal.[13]

Scaling Up Aid Inflows

26. **The authorities estimate that achieving annual growth of about 7–8 percent over the medium term would require US$1.25 billion (about 75 percent of GDP) in aid over the period 2008-10.**[14] Their priority infrastructure projects are to improve the road network that links the country with transit points for merchandise, which would reduce the transportation costs associated with international trade; construct roads to open up the interior of the country, the isolation of which inhibits the development of the agricultural sector; rehabilitate the electrical utility (~~less than 7~~ only 3 percent of the population has access to electricity); and extend the supply of potable water and sanitation facilities to the interior, which would have a predictable impact on the health of the poorest among of the population.

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[12] The authorities envisaged an initial bond offering of CFAF 45 billion (about 0.5 percent of GDP), with an interest rate of about 8 percent per annum, which is lower than the interest charges on statutory advances from the central bank (10 percent) and short-term borrowing from commercial banks (15-20 percent).

[13] Also, the staff encouraged the authorities to seek technical assistance to better understand the modalities of such borrowing, and to enhance debt management to ensure its consistency with debt sustainability.

[14] In late October 2007, the C.A.R. government will present its finalized PRSP at a donor roundtable. The financial assistance pledged during this roundtable will be an important input both for planning the 2008 budget and for the medium-term growth strategy.

27. **While staff did not challenge the estimates of aid needed to finance priority investment projects, it did raise concerns about capacity constraints.** Staff noted that the authorities' resource requirements were about 12 times the amount of donor assistance committed this year and stressed that the pace of scaling up would need to take account of the country's absorptive capacity in terms of both macroeconomic and institutional constraints (see Box 2). On the macroeconomic side, the "speed limit" would be set by how quickly the productive capacity of the country could grow; if the limit is exceeded, internal disequilibrium would follow, probably in the form of much higher inflation that would hit the poor and the vulnerable hardest. On the institutional side, the country would need to build sufficient administrative and implementation capacity to spend scaled-up inflows productively. The authorities acknowledged these capacity constraints and indicated their intention to address them in their PRSP.

Box 2. The Medium-Term Outlook and Capacity Constraints

While there is little doubt about the need for scaling up aid inflows to accelerate growth and alleviate poverty in the C.A.R., there is some question about the pace of inflows. The authorities estimate that financing the PRSP over 2008–10 would require aid inflows about 12 times the amount of foreign disbursements projected for 2007.

Clearly, the pace of scaling up will be limited by absorptive capacity. During the discussions, the authorities' "dynamic medium-term scenario" was assessed alongside the staff's alternative and "capacity-constrained scenario." There were some important differences.

In the authorities' scenario, growth accelerates from 8.4 percent in 2008 to 11.4 percent in 2010, largely from a substantial increase in public investment; indeed, the public-investment to GDP ratio rises ~~tripples~~ from less than 10 percent currently to above 30 percent. The staff scenario has GDP growth increasing moderately to about 6½ percent over the medium term, supported by a much smaller increase in public investment.

To derive the capacity constrained scenario, the staff considered (i) the potential supply response to additional capital accumulation using an aggregate production function, (ii) scope for (and limits to) expanding human capital (given the limited supply of skilled labor), and (iii) broad institutional capacity. The experience of other sub-Saharan countries with scaling up also provided guidance; for nearly all of all these countries, capacity constraints led to only a gradual rise in the investment-GDP ratio, which is reflected in the staff's scenario.

Central African Republic: Alternative Medium-Term Scenarios

	Baseline scenario (PRGF arrangement)			Authorities' scenario ("dynamic")			Alternative scenario (capacity constrained)		
	2008	2009	2010	2008	2009	2010	2008	2009	2010
Real GDP growth 1/	4.2	4.5	4.2	8.5	9.7	11.4	5.3	5.9	6.5
Investment 2/	10.1	10.4	10.5	23.8	28.3	31.4	13.4	13.5	15.0
Public	3.4	3.6	3.7	17.8	22.0	24.7	4.9	5.3	6.3
Private 3/	6.6	6.8	6.8	6.0	6.3	6.7	8.5	8.1	8.7
Fiscal revenue	10.8	11.3	11.6	11.4	12.3	12.9	11.3	12.0	12.6
Current expenditure 2/	9.0	9.0	9.3	10.7	11.4	12.0	9.5	9.8	10.3
Foreign aid 2/	3.6	3.5	3.2	13.8	20.2	29.7	5.0	5.1	5.7

1/ Annual percentage change.
2/ Percent of GDP.
3/ Alternative scenario reflects projected increases in foreign direct investment.