

**FOR
AGENDA**

EBS/08/105
Supplement 2

September 10, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Djibouti—Staff Report for the 2008 Article IV Consultation and Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility—Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding**

Attached for consideration by the Executive Directors is a letter of intent, memorandum of economic and financial policies, and technical memorandum of understanding from the government of Djibouti. This subject, together with the staff report for the 2008 Article IV consultation with Djibouti and Djibouti's request for a three-year arrangement under the Poverty Reduction and Growth Facility (EBS/08/105, 9/4/08), is tentatively scheduled for discussion on **Wednesday, September 17, 2008**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of Djibouti indicating whether or not they consent to the Fund's publication of this paper.

Questions may be referred to Mr. Delgado (ext. 34142), Mrs. Beidas-Strom (ext. 38922), Mr. Pani (ext. 38536), and Mr. Puig (ext. 37701) in MCD.

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

Att: (1)

Other Distribution:
Department Heads

Djibouti, September 10, 2008

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

The government of Djibouti has adopted a three-year economic and structural adjustment program based on the National Initiative for Social Development (INDS), launched by the government in January 2007 and considered to be the country's Poverty Reduction Strategy Paper (PRSP). The main components of the program are described in the attached Memorandum on Economic and Financial Policies (MEFP) for the period 2008–11. In addition, the MEFP provides details on the government's proposed objectives and on the policies it plans to implement during the period 2008–09. You will also find herewith a Technical Memorandum of Understanding (TMU) covering a number of concepts and definitions as well as the data to be reported within the framework of the program.

Djibouti is at a critical stage of its development. To maintain macroeconomic stability, continue stimulating foreign and domestic private investment, fuel growth, reduce poverty, and achieve the Millennium Development Goals (MDGs) with the help of the international community, we plan to accelerate our economic and social reforms and link them to policies designed to support sustained and broad-based growth. Institutional reforms will be essential for fostering technological and organizational change and for drawing on the currently abundant foreign investment flows with a view to creating enough jobs for a large portion of the population.

We hereby request a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF), totaling SDR 12.72 million (80 percent of the quota), to support our program. We also request that the first disbursement under the arrangement, for an amount equivalent to SDR 3.864 million, be made available to Djibouti upon approval of the PRGF arrangement by the IMF Executive Board.

The government of Djibouti believes that the economic policies and measures described in the attached MEFP are apt to ensure achievement of the objectives of the program that will be supported by the PRGF arrangement. However, it will take any further measures that may prove necessary to that end. The government will also consult with the IMF on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in

accordance with IMF policy on consultations, and will provide the IMF with any information it may need to assess progress made by the authorities in implementing the policies described in the MEFP.

The government will provide the IMF with any information it may request for the purposes of monitoring progress in the implementation of economic and financial policies and determining the measures necessary for achievement of the program objectives. A TMU is attached, describing the performance criteria and the quantitative and structural benchmarks of the program. Djibouti will observe the schedule of semi-annual reviews, the first of which is expected to be completed by end-March 2009.

Sincerely yours,

/s/

Ali Farah Assoweh
Minister of Economy, Finance,
and Planning In Charge of Privatization

/s/

Djama M. Haïd
Governor
Central Bank of Djibouti

Attachments

- I. Memorandum on Economic and Financial Policies
- II. Technical Memorandum of Understanding

ATTACHMENT I TO LOI. MEMORANDUM ON ECONOMIC AND FINANCIAL POLICIES

I. INTRODUCTION AND BACKGROUND

1. This memorandum describes the economic and financial program adopted by the government of Djibouti within the framework of the three-year arrangement with the International Monetary Fund (IMF) for the period 2008–11, under the Poverty Reduction and Growth Facility (PRGF). During this period, we expect to consolidate macroeconomic stability and lay a sound foundation for sustaining broad-based economic growth, especially with a view to reducing poverty and unemployment. Such an outcome is essential to achieving the Millennium Development Goals (MDGs) and maintaining broad support for economic and financial reform. Our medium-term economic and financial strategy will be consistent with the National Initiative for Social Development (INDS), launched by the government in January 2007 in consultation with the stakeholders and our development partners and representing our second-generation Poverty Reduction Strategy Paper (PRSP).

2. Our strategy is geared toward creating the conditions for: (a) placing the economy on a path of sustainable growth with a view to reducing unemployment, mitigating poverty, and improving the country's social indicators; (b) ensuring domestic financial stability, in particular by controlling inflation, which adversely affects especially the poor; (c) moving closer to a more viable external position over the medium term, notably by increasing competitiveness and maintaining prudent management of foreign indebtedness; (d) improving fiscal management and transparency, so as to achieve proper expenditure targeting and prioritization in such a way as to free up resources to finance poverty reduction programs; and (e) strengthening administrative and institutional capacities in various areas, especially statistics.

3. The satisfactory conclusion of the 2005 staff-monitored program (SMP) helped improve conditions for private investment and increase external competitiveness in a number of areas. In particular, progress has been made toward: (a) unifying and simplifying the tax exemption system by merging the various preferential tax regimes and incorporating the remainder of them into the General Tax Code; (b) computerizing expenditure procedures; (c) eliminating the practice of exchanging checks with the national water authority (ONEAD) and the national telecommunications agency (Djibouti Telecom); (d) limiting advance payment authorizations of expenditure covered by legislation; (e) preparing a new Commercial Code; (f) publishing the audited financial statements of the principal public enterprises; and (g) setting up a new single payroll and civil service file.

4. In 2006–07, Djibouti's economic outlook improved significantly, largely because of policies we implemented to modernize and develop our economy by promoting wide-ranging foreign investment programs. Taking advantage of our strategic position on the Horn of Africa and on the planet's most frequently used sea route, our political stability, and our membership in the Common Market for Eastern and Southern Africa (COMESA), we have

succeeded in attracting about US\$1.2 billion in confirmed foreign direct investments (FDI) for the period 2008–13, that is, equivalent to 140 percent of GDP in 2007. The linchpin of those investments is the construction of a new deep-water port on the Doraleh site, where the oil terminal is already in use, and the first phase of the container terminal is scheduled to become operational at end-2009. This new port, also managed by Dubai Ports World (DPW), will enable Djibouti to better serve Ethiopia's needs, in fulfillment of what has been its principal vocation for more than a century but also to diversify the port business by developing our share in the trans-shipment market toward other countries of the region, for which a huge market is now being created. Other investments go hand in hand with this major project, notably the improvement of land communications with Ethiopia, the creation of a hotel and tourism infrastructure, the expansion of the export processing zone, the implementation of large capital projects in the areas of water and power, the installation of an oil refinery with a capacity of 45,000 barrels a day, operations in the salt mining industry, and the development of financial services. Infrastructure investment is supported by an education policy aimed at providing universal access to secondary education by 2015.

5. Nevertheless, huge challenges remain to be met in coming years. First, steps must be taken to ensure that the FDI rate is maintained, and that growth is not limited solely to an enclave around the port. Second, although economic outturns have improved significantly over the past two years, highly capital-intensive projects have so far had only a slight impact on job creation and fiscal revenue. The links must therefore be strengthened between the large FDI inflows and the domestic economy, for a larger portion of the population to benefit from growth, primarily by fostering the creation of jobs for the people of Djibouti but also by freeing up budgetary resources that will enable us to finance the social programs that are greatly needed by the people. In this regard, we are aware that widespread, sustained growth is dependent upon the implementation of in-depth structural reforms, in particular the improvement of our institutions and human capital, with a view to increasing productivity, enhancing our international competitiveness, and encouraging private sector development, especially of small and medium-sized enterprises (SMEs).

6. The government is also aware of the need to consolidate the country's macroeconomic stability. This involves primarily combating inflation, which has an adverse impact especially on the poor, while providing budgetary resources that are sufficient for implementation of the poverty reduction strategy. To that end, we shall strengthen revenue mobilization, streamline expenditure, and increase fiscal transparency. In addition, we plan to remove gradually the restrictions on wholesale and retail food distributors' margins that were temporarily introduced with respect to a few staples to curtail the rise in commodity prices, and to implement reforms to increase competition and open up the economy further. For its part, the Central Bank of Djibouti (CBD) is determined to enhance its capacity to manage liquidity so as to bring down the inflation rate to a level close to international rates. The implementation of this program will require firm economic management as well as efforts with the international community to obtain more financial and technical assistance.

7. The remainder of this memorandum is devoted to a review of recent economic developments, a description of the main components of the government's economic program for 2008–11, and a presentation of the measures and actions planned for the first year of the program (September 1, 2008–August 31, 2009).

II. RECENT ECONOMIC DEVELOPMENTS

8. The economic environment in Djibouti has improved considerably in recent years, but inflationary pressures have intensified. Preliminary estimates suggest that real GDP growth has accelerated, rising from 4.8 percent in 2006 to 5.3 percent in 2007, especially as a result of the FDI flows into the port and construction sectors. The investment ratio has nearly doubled in the space of two years, from 23 percent of GDP in 2005 to 42 percent in 2007. However, the 12-month inflation rate at end-2007 reached 8.2 percent, compared with 3.5 percent in 2006, then increased further to nearly 10.3 percent at end-April 2008, primarily because of the rise in international food and oil prices. The rate of expansion of credit to the private sector quickened to 9 percent in 2006 and to 23 percent in 2007, reaching nearly 30 percent year on year at end-April 2008, partly as a result of the real estate and construction boom and the recent arrival of new foreign banks on the market, which promoted competition, thus reducing financial intermediation margins.

9. The external current account deficit widened from 15 percent of GDP in 2006 to about 25 percent in 2007, following the strong increase of imports related to the new investments.¹ This deficit was more than covered by the surplus on the financial and capital accounts resulting from inflows of capital, especially of FDI, which led to an increase in the gross official reserves to US\$130 million at end-2007 (equivalent to 1.9 months of imports of goods and services and 116 percent currency board coverage). The gross official reserves have continued to increase, reaching US\$135 million at end-April 2008. The Djibouti franc depreciated by about 4 percent in real effective terms, because of the weakening of the U.S. dollar to which it is pegged.

10. On the fiscal side, the overall budget balance on a commitment basis posted a deficit of 2.6 percent of GDP in 2007, a figure close to that of 2006. The reduction of current expenditure from 29.9 percent of GDP in 2006 to 26.5 percent in 2007 (partly as a result of the exceptional increase in spending in 2006, related to the regional elections and to the COMESA Summit) was offset by the upturn in investments. Accordingly, the basic deficit narrowed from 7.2 percent of GDP in 2006 to 4.9 percent in 2007. Notwithstanding, compared with the 2007 Budget Law, budget execution was expansionary in 2007 because of the rise in international prices, the appreciation of the Euro, the introduction of the INDS, and spending related to the preparation of the February 2008 parliamentary elections. Tax

¹ The current account deficit, excluding FDI-related imports, is estimated at 3.7 percent of GDP in 2006 and at 5.1 percent of GDP in 2007.

collection for the current year declined to 19.1 percent of GDP in 2007, down from 19.8 percent in 2006, because of the shortfall generated by the exemptions granted to investments in the port, the export processing zone, and the tourism sector. However, total tax receipts remained steady at about 20 percent of GDP, as a result of exceptional revenue collection for the previous periods (in particular, through an exchange of checks (cross-offsetting) between the government and the national electricity company—EDD), on the order of 1.4 percent of GDP. Nevertheless, the increase in external financing facilitated a net refund of domestic and external arrears, for an estimated amount equivalent to about 0.7 percent of GDP, despite the accumulation of further external arrears.

11. Considerable progress continued in the implementation of structural reforms. The government adopted a new Labor Code in December 2005, which came into force in 2006. The physical audit of the civil service was completed in 2007. Three key measures in the 2005 staff-monitored program have been implemented, and our PRSP has already been posted on the website of the Ministry of Economy, Finance, and Planning, Responsible for the Privatization (MEFPP). IMF technical assistance (TA) has helped us enormously to define some components of the ongoing reform in the fiscal, financial, and statistical areas. On the fiscal side, such TA has been provided in the area of tax reforms—in particular, the introduction of VAT and the improvement of cash management and of the budget and accounting classification system. On the financial side, the Report on the Observation of Standards and Codes (ROSC) with respect to anti-money laundering activities falls within the framework of the Financial Sector Assessment Program (FSAP)—a joint initiative of the IMF and the World Bank, is currently scheduled for completion at end-2008. As regards statistics, TA was provided to improve the compilation and classification of the balance of payments statistics and monetary statistics as well as to implement the International Financial Reporting Standards (IFRS) at the CBD.

III. MEDIUM-TERM MACROECONOMIC FRAMEWORK

12. In light of our strategic objectives and the large increases in oil and food prices, our medium-term economic policy will be aimed at: (a) raising annual real GDP growth to about 7 percent, on the basis of the expected FDI inflows and their impact on the economy and of the effects of fiscal stabilization and structural reforms; (b) controlling the inflation rate to reduce it to a level close to 3–3.5 percent through rigorous budget management, structural measures aimed at increasing productivity, and the introduction of new money management instruments; and (c) supporting the integrity and credibility of the currency board by keeping at least a 105 percent rate of coverage. Improving the competitiveness of our economy and strengthening the production and transportation infrastructure should lead to an acceleration in the growth of exports of goods and services. With medium-term financing requirements continuing to be met from grants, concessional loans, and the ongoing flows of private capital in the form of FDI, the country's external position will be manageable. The gross foreign currency assets of the CBD are expected to grow only gradually to cover 1.9 months of imports of goods and services at end-2011.

13. To increase poverty reduction expenditure while ensuring fiscal viability and greater competitiveness of the economy, our medium-term fiscal and structural framework will be designed to ensure that the overall budget during the period 2008–11 is balanced, and that competitiveness will be improved. To this end, we shall take steps to: (i) implement an overall reform of the tax system so as to streamline it, broaden the tax base, control exemptions, increase tax revenue by about 1.8 percent of GDP between 2008 and 2011, and tailor the tax system to meeting our international commitments within the COMESA and the World Trade Organization (WTO); (ii) strengthen the tax administration; (iii) reduce the share of wages in current expenditure by containing nominal wage increases (except merit increases) and freezing public sector hiring (except in the social sectors), which will enable us to reduce the wage bill to GDP ratio from 12.4 percent in 2007 to 10.3 percent in 2011; (iv) adopt measures to control expenditure on goods and services; (v) adopt measures to contain the contingent liabilities of public enterprises in deficit (in particular, the EDD) by enhancing their competitiveness and reducing their operating costs; and (vi) improve reporting on fiscal management, notably through the quick dissemination of fiscal data. Measures will also be taken to achieve better human resources management in the public sector, based on the indications provided by the physical audit of the civil service and the ongoing organizational and strategic audits, with the strategic aim of modernizing and streamlining government departments while containing personnel costs. Modernization of the civil service is key to the government's strategy. The overall improvement of human resources management may include tailoring staffing to needs; strengthening competency and merit criteria in recruitment, remuneration, and promotions; updating the civil service general rules and regulations; and adopting a new Code of Conduct. To strengthen its capacities, the government intends to request TA from its development partners during the round table conference scheduled for November 2008.

14. Other structural measures will be aimed at strengthening the statistical framework, improving the business climate, and enhancing governance and the labor market. Regarding the development of the CBD's capacities for supervision and money management, we will move expeditiously to consider implementation of the FSAP recommendations in areas considered urgent and frame our medium-term policy along the lines of the guidance provided in the program.

IV. THE ECONOMIC PROGRAM FOR 2008–09

15. Our objective for the first year of the program, which covers September 1, 2008 to August 30, 2009, is to achieve a growth rate of 5.9 percent in 2008 and 6.9 percent in 2009 while reducing inflation, year on year, to 5.5 percent at end-2009. To achieve this, we will have to maintain fiscal moderation in light of persistently high international oil and food prices. The growth target will be sustained by the large volume of FDI already committed for the expansion of the port, the export processing zone, and the pertinent infrastructure, in particular as relates to power, water, and the oil refinery.

16. The evolution of the external current account will be largely determined by the ongoing projects related to the major FDI projects. The external current account deficit is expected to remain substantial in 2008–09, following an upsurge of imports related to these new investments. The deficit however will no longer be covered by the increase in the surplus on the financial and capital accounts generated by the upturn in FDI but by the disbursement of funds from donors and lenders. Accordingly, the external position should be manageable, and we hope to increase the foreign reserves gradually from US\$131 million in 2008 to US\$143 million at end-2009 (equivalent to 1.7 months of imports). We expect the external public debt to stabilize at about 56 percent of GDP in 2009.

A. Fiscal Policy and Reform

17. Fiscal policy will be the principal instrument used to implement the macroeconomic framework defined in the new PRSP. Our economic program provides for a large increase in poverty reduction expenditure. The execution and financing of this expenditure will remain consistent with macroeconomic stability. To this end, concerted efforts will be needed to improve fiscal management.

18. Our fiscal policy will be designed to ensure a narrowing of the overall deficit, on a commitment basis, from 2.6 percent of GDP in 2007 to 1.9 percent in 2008 and to 1.8 percent in 2009. We are also determined to reduce the stock of domestic payment arrears by 2.5 percent of GDP in 2008–09 and to clear all the external arrears by end-August 2008. We will negotiate a multilateral agreement with the Paris Club shortly, and follow suit with bilateral agreements under the terms set by the multilateral agreement. In addition, we are determined to avoid the accumulation of further arrears and we intend to request technical assistance to improve current debt management practices. Furthermore, the government will initiate measures to increase tax revenue and reduce nonpriority current expenditure.

19. On the revenue side, our strategy is geared toward introducing VAT in January 2009, as already announced in the 2008 Budget Law. The pertinent draft law, regarding which we received TA from the IMF Fiscal Affairs Department, will be placed before the National Assembly at the same time, at the latest, at the time of the 2008 supplementary budget, and at any rate, by end-November 2008. There will be a single general VAT rate of at least 7 percent, to be implemented as of the 2009 budget, and this will produce net revenue equivalent to about 1.1 percent of GDP in 2009.²

² The full elimination of the CIT and the introduction of the COMESA's common external tariff (CET) are now scheduled for 2010, following a delay in adopting the common rates at the ministerial level within the COMESA.

20. To increase the mobilization of resources necessary for achieving our poverty reduction objective, we intend to adopt, by end-August 2009, measures designed to modernize the tax administration and improve collection, in particular by increasing the number of Tax Department employees, to promote taxpayer compliance, and to enhance collection by strengthening inspections and restructuring the tax collection organization, in accordance with the recommendations of the IMF Fiscal Affairs Department (FAD) TA missions. In addition, further measures will be adopted to simplify the tax system and broaden the tax base while consolidating the tax administration. These measures include the following: (i) by end-November 2008, revise the schedules of the personal income tax (ITS), in accordance with the recommendations of the FAD TA missions, with a view to creating more equity and protecting incomes in the context of poverty reduction; (ii) by end-February 2009, revise some provisions of the Free trade Zone Law to prevent distortions in the social security system and in the taxation of wages; and (iii) by end-February 2009, revise the Investment Code to streamline tax exemptions (duration of exemptions, list of tax benefits) and strengthen the procedures and resources for monitoring exempt projects. Lastly, we shall redouble our efforts to collect outstanding taxes from previous financial years by improving the technical management of the Tax Department.

21. We also intend to adopt measures designed to increase the effectiveness of public expenditure and cash management. In this regard, we plan to merge the government accounts throughout the banking system into a single Treasury account, by end-May 2009. We shall continue preparing the treasury's Monthly Cash Flow Plans, based on precise estimates of revenue and of expenditure requirements, and shall improve the process of budget preparation, taking account of the recommendations of the FAD TA missions. In particular, we shall revise the budget classification (by end-August 2009) and begin preparing, with TA from the IMF (by end-August 2009) a comprehensive medium-term budget framework that will include all government expenditure and will serve as a basis for preparation of the 2010 Budget Law. We shall link the IT system of the Finance Department and the Treasury (by end-February 2009) with technical and financial assistance from the European Union; and (by end-February 2009) we shall improve the functionalities of the IT system of the Finance Department, in particular by setting up automatic rejection and alert notifications whenever budget appropriations are exceeded. To increase the liquidity of the government accounts (by end-2008) we shall reduce net banking system credit to the government (stock compared to the beginning of the year, excluding counterpart funds from the IMF and the Arab Monetary Fund (AMF) by DF 500 million.

22. Efforts will continue to meet the quantitative benchmarks and performance criteria of the program, with the adoption by end-September 2008 of a revised 2008 budget and, by end-December 2008, of a 2009 budget, both of which will be consistent with the quantitative benchmarks and performance criteria set in the macroeconomic framework agreed between the authorities and the IMF mission. In the context of the program, the ratio of current expenditure to GDP is expected to fall from 26.5 percent of GDP in 2007 to 24 percent of GDP in 2009, as a result of a reduction, in GDP terms, of nonpriority spending on goods and

services and better control over wage bill increases. The centralization, as of August 2008, of public procurement of government departments through a Central Purchasing Office will reduce average purchase costs by achieving economies of scale. The control of current expenditure will be facilitated by the freezing of recruitment in the public sector (except for the Ministries of Health and Education and the Tax Department) and of the structure of nominal wages (excluding promotions), which we intend to maintain until the end of the program, as well as through completion of the civil service reform, facilitated by the finalization of the physical, organizational, and strategic audits and the establishment of the new single payroll and civil service file. These measures are expected to free up the additional resources necessary for increasing expenditure on poverty reduction (especially in health and education).

23. We estimate that public capital expenditure (primarily on infrastructure and social projects) will be maintained at about 11 percent of GDP in 2008, financed largely by grants and concessional external loans. To mobilize financial support, we shall organize a conference of external donors and lenders by November 2008 and initiate bilateral negotiations.

24. The government will continue to abstain from seeking credit from the banking system. We shall also avoid accumulating further external and domestic payment arrears, including with respect to government-guaranteed debt, and are determined to reduce domestic arrears by a sum equivalent to 1.2 percent of GDP, by end-2008.

25. We shall also continue to strengthen fiscal management communications. We shall publish regularly, in addition to the year-end preliminary budget execution data (within five months of year-end), the monthly fiscal reporting table (TOFE—within 60 days of each month-end), and the audited accounts of the social security fund and the major public enterprises (within nine months of year-end). We shall also prepare detailed annual reports on priority poverty-reduction social expenditure, which will be published within a period not exceeding six months.

26. Institutional development is key in the context of the new program. The government will make every effort to build capacity in the areas of project planning, programming, and preparation. Similarly, the rate of public expenditure implementation will be accelerated in the context of the reform of the Public Procurement Code, under preparation with World Bank assistance.

27. To facilitate monitoring of the program, we shall forward to IMF staff: (i) the TOFE, within 60 days of each month-end; (ii) quarterly balance of payments statistics, within one quarter, starting from the third quarter of 2008; (iii) monetary and consumer price index (CPI) data, within four weeks; and (iv) a monthly list of medium- and long-term public and publicly guaranteed loans, with indications, for each loan, of: the creditor, the borrower, the

amount, the currency, the due date, the grace period, and the arrangements concerning interest rates, within four weeks of each month-end.

B. Foreign Exchange, Monetary, and Financial Policies

28. The currency board arrangement has served the economy well by ensuring price stability, which has helped improve external competitiveness in recent years while consolidating private sector confidence. The government intends to maintain the exchange rate peg to the dollar in the context of the currency board. In this regard, the CBD will rigorously cover its monetary commitments denominated in foreign currencies, with a hedge ratio representing at least 105 percent of the currency in circulation.

29. The authorities wish to strengthen liquidity management and improve the effectiveness of financial intermediation. Accordingly, to be able to absorb excess liquidity from the banking system and contribute to price stability, the CBD will formulate a project for introducing a new monetary instrument, that of reserve requirements on deposits. The reserve ratio to be applied to deposits, the rate of remuneration of those reserves, the deposits to be subject to reserve requirements, and other characteristics of this instrument will be defined in consultation with the local banks and with TA from the IMF; the implementation of this mechanism is scheduled for August 31, 2009.

30. Increased competition within the financial system following the installation in the market of three new banks over the past two years should help reduce the cost of credit further. Domestic credit to the private sector is expected to increase by about 35 percent in 2008 and by 29 percent in 2009. It is anticipated that broad money will grow slightly below the rate of nominal GDP growth during 2008-09. In accordance with these projections, the authorities are also working closely with the banks to encourage them to expand the range of financial products they offer their customers.

31. The CBD has undertaken to strengthen its supervisory capacity so as to better ensure the integrity of the expanding financial system. To meet the new requirements, we are determined to build banking supervision capacity in accordance with the Basel principles, by end-August 2009. This involves, among other things: (i) increasing the staffing of the CBD and improving the technical skills of staff in the area of banking supervision, and establishing a schedule for more regular on-site supervision (one inspection will be carried out by end-February 2009, and two additional inspections will be conducted by end-August 2009); (ii) considering the application of accounting and regulatory standards to Islamic banking; and (iii) doubling the required minimum capital of banks from DF 300 million to DF 600 million, with a grace period for adaptation of the existing banks. In this context, the upcoming FSAP mission will help to highlight the vulnerabilities of the new expanded financial system and strengthen its role as a catalyst for economic growth.

32. The government is also doing its best to increase the effectiveness of monitoring anti-money laundering (AML) and combating the financing of terrorism (CFT), by following the recommendations of the recent IMF Legal Department mission. In this regard, the authorities will take the following measures: (i) continue to raise awareness of AML/CFT practices in the public and private sectors; (ii) by end-August 2009, increase the staffing of the Financial Intelligence Unit (FIU), its resources, and its independence, so that it can properly carry out its mission, taking into account the recommendations of the IMF Legal Department's AML/CFT mission; and (iii) by end-February 2009, approve additional decrees or update and send the AML/CFT Law to the National Assembly (as applicable) for enforcing the following provisions: (a) investigate and prosecute violators; (b) freeze the assets of suspected terrorists, pursuant to the pertinent Resolutions of the United Nations Security Council; and (c) include nonbank financial institutions among those to be supervised for enforcement of the law by the CBD.

C. External Sector Policies

33. The authorities are determined to maintain the existing free trade system. There are no foreign exchange restrictions on current account or capital account transactions, and trade is completely open; imports and exports are not subject to any prohibition. Moreover, we fully intend to adopt the COMESA's common external tariff (CET) as soon as an agreement is reached by the member countries on the applicable rates and the other technical aspects being defined, which will help allay the concerns recently expressed by the WTO.

34. The economic reform program being conducted by the authorities is also aimed at improving export outturns—in particular, accelerating exports of livestock, transportation, and related services—and encouraging the creation of light industry, especially in the Free Trade Zone. Exports grew considerably in 2007, partly as a result of the commissioning of a regional center for livestock re-export in Djibouti at end-2006 and the strong growth of the Ethiopian economy, which is currently the principal destination for goods and services exported from Djibouti.

35. To improve the sustainability of its external debt, the government will not contract or guarantee nonconcessional loans. It will also be necessary to prevent public enterprises from borrowing on nonconcessional terms, except in exceptional circumstances and after consultations with IMF staff. The recent agreement to swap a portion of the external debt to Italy into social projects is a step in the right direction. We shall pursue negotiations with other Paris Club creditors once a new multilateral agreement is reached. The authorities will provide IMF staff with all the details about the amount and the characteristics of each new loan and will keep them informed of progress in the discussions with creditors. The authorities will also strengthen their management of the external debt by increasing the frequency of controls and analyses of the debt monitoring system, which is already computerized, and by expanding the capacities of this system.

D. Competitiveness, Public Enterprises, and the Private Sector

36. The authorities are determined to implement a policy of improving the country's external competitiveness. Although estimates of the real effective equilibrium exchange rate show a gradual correction of the overvaluation of the Djibouti franc, several competitiveness indicators suggest competitiveness remains poor, and this can be attributed primarily to the high costs of the principal factors of production (power, telecommunications, and labor), which continue to hamper private sector development. We therefore intend to adopt structural reforms designed to reduce the costs of domestic production and improve the business climate. Specific measures will be taken to: (a) enhance the legal and regulatory framework for business; (b) reduce the costs of production factors; and (c) improve the labor environment.

37. Enhancing the legal and regulatory framework for business will start with the submission of the new Commercial Code, prepared with assistance from the European Union, to the National Assembly by end-November 2008, and the subsequent streamlining of the procedures for the creation of enterprises. We shall also strengthen coordination of the one-stop shop at the National Investment Promotion Agency (ANPI) with the other departments concerned with private investment (Tax Department, Customs, etc.) by end-February 2009, which will enable new enterprises to start up more quickly and at lesser costs.

38. As regards reducing the costs of production factors, we have decided to go forward with the restructuring and fiscal consolidation of our principal public enterprises (Djibouti-Telecom, ONEAD, and EDD), so as to improve the quality of their services, ensure their financial viability, and increase their productivity. These enterprises in difficulty (especially EDD) place great strain on the government budget, while the rates in effect, which do not cover operational costs, constitute an increasingly heavy burden on the consumer and on investors. More specifically, the authorities have undertaken to: (i) draw up an action plan, by February 2009, for implementing the recommendations of the study on the strategy for reducing the technical losses of the ONEAD; (ii) reorganize and adjust the staffing of EDD with a view to reducing personnel costs—in accordance with the results of a study to be undertaken by an independent, specialized international firm regarding the scope of this adjustment—with plans for early retirement and the redeployment of excess employees to other short-staffed public utilities (the report and recommendations will be concluded by end-August 2009, and a progress report on the study will be produced by end-February 2009); and (iii) complete the study financed by the World Bank on the source of the electricity distribution losses, by end-August 2009. We are also planning to build the institutional capacity of the Ministry of Energy and draw up an energy efficiency plan to increase electricity consumption savings, with assistance from the development partners.

39. At the same time, we intend to develop alternative energy supply sources. On the one hand, we are seeking to explore, as a priority, geothermal, solar, and wind energy in Djibouti,

and on the other hand, a major agreement was signed with Ethiopia to link our networks; this will enable us to import electricity from that country. The link with Ethiopia will help us reduce our production costs considerably; to that end, we intend to settle, by end-May 2009, within the framework of the electricity purchasing agreement with Ethiopia, on the tariff rates to be applied to the electricity bought through the connecting line.

40. Finally, implementation of the new Labor code, which is the legal framework for the labor market, is also a priority for improving the business climate. In this context, we shall take measures designed to facilitate hiring and the creation of enterprises on the basis of the new Labor Code; this will make the labor market more flexible. In particular, we shall by end-May 2009 adopt the remaining implementing decrees for the Labor Code and by end-August 2009 renegotiate all collective bargaining agreements within the periods prescribed by the Code.

41. The authorities are aware of the pertinence of strengthening governance and institutional transparency to improve the business climate further. For this purpose, we undertake to boost the General Finance Inspectorate (IGF) by: (i) restructuring it (by end-May 2009), (ii) formulating for it an annual program of missions for 2009 (by end-November 2008), and (iii) continuously building the skills of its personnel.

E. Statistical and Other Issues

42. Because the quality of our statistical database is still poor, our policy formulation efforts continue to be hampered. For the future, measures will also have to be taken, with the help of the IMF, the World Bank, and other development partners, to improve the quality, coverage, and timeliness of economic data; and to strengthen national accounting, the quality of the balance of payments data, and the compilation and coverage of government finance statistics, based on the recommendations of the IMF technical assistance missions. We shall improve coordination among the Statistics and Demographic Studies Department (DISED), the CBD, and the various MEFPP departments, including Customs, with a view to creating a sound statistical base covering the entire country. In particular, by end-February 2009, we shall carry out a full population census. Early in 2009, when the census has been completed, we intend to begin a survey to test the results that will be used as the polling basis in the poverty survey, which is expected to be completed at end-August 2009 and will be followed by a comprehensive household expenditure survey. This will help us revise the weights used in the CPI basket and update the various social indicators, in particular to provide new poverty and income distribution estimates. The information will be forwarded to the IMF and the international community by end-2009. By end-August 2009, we shall also complete an economic activities survey, with support from our development partners, to integrate the data in the estimated national accounts. Our intention is to provide sufficient resources, including personnel, to the units responsible for carrying out these surveys, so as to produce better source data.

43. We shall cooperate fully with the upcoming safeguards assessment mission, which is scheduled to take place by the time of the first review of the PRGF-financed arrangement. Based on the findings of that mission, we shall formulate a strategy to make up for any shortcomings in the legal framework and financial controls of the CBD, and provide, where applicable, for specific remedial measures to be included in the program.

V. RISKS FOR THE PROGRAM

44. We are determined to launch a vigorous program of reforms and seize the opportunities presented by the arrival of exceptionally high FDI. However, the success of the program is subject to major risks and constraints. First, the wide-ranging and thorny reforms, such as the freezing of recruitment in the public sector (except for the Ministries of Health and Education and the strengthening of the Tax Department) and of the structure of nominal wages (excluding promotions), may well lead to political and social pressures that can hinder implementation of the program. Second, the absorption capacity and implementation constraints may prevent us from carrying out the reforms quickly enough to meet the needs of the huge FDI inflows. Third, regional stability may also constitute serious risks. Finally, further oil and food price increases may well reignite inflation and place budget sustainability in jeopardy.

VI. PROGRAM MONITORING

45. For program implementation and monitoring, a constant effort will be required to improve Djibouti's economic and financial statistics. The authorities will take all necessary measures in this area and will request additional technical assistance, if needed. They will forward in a timely manner any information requested by IMF staff, in accordance with the calendar set forth in the TMU attached to this memorandum. The first and second reviews of the program are scheduled for completion, respectively, by end-March 2009 and end-September 2009. As regards the first review, compliance with the quantitative performance criteria established for end-December 2008, as shown in Table 1, and with the end-November structural performance criterion described in Table 2, will also be monitored. Quantitative benchmarks have also been set for end-September 2008 and end-March 2009 (Table 1), and the TMU will present more in-depth definitions and explanations.

46. Based on the above-mentioned monitoring indicators and under the authority of the Minister of Economy, Finance, and Planning, Responsible for Privatization, the Secretary-General of that Ministry will coordinate the technical data necessary for monitoring the program.

47. In addition, the government will not impose any restrictions on payments related to current international transfers and transactions that would be inconsistent with the country's obligations under Article VIII of the IMF Articles of Agreement.

Table 1 .Djibouti: Performance Criteria and Indicative Targets, 2008–09
(In millions of Djibouti francs; unless otherwise indicated)

	Cumulative Flows from Beginning of the Year (unless otherwise indicated)							
	2007		2008		2009			Indicative Targets
	Dec. 31 Estimate	Sept. 31 Indicative Targets	Dec. 31 Performance Criteria	Mar. 31 Indicative Targets	Jun. 30 Performance Criteria	Sept. 31 Indicative Targets		
Performance criteria and benchmarks								
I.	Ceiling on accumulation of new domestic arrears (MEFP ¶18, ¶24, TMU ¶50) 1/ 2/	4,416	0	0	0	0	0	0
II.	Ceiling on accumulation of new external arrears (MEFP ¶18, TMU ¶51) 3/ 2/	1,560 4/	0	0	0	0	0	0
III.	Clear outstanding external arrears (MEFP ¶18, TMU ¶51)	6,220			0 5/			
IV.	Ceiling on net credit to government from the banking system (MEFP ¶21, ¶24, TMU ¶52) 6/	113	0	-500	0	-100	-500	
V.	Ceiling on new medium- and long-term nonconcessional loans contracted or guaranteed by the government or by the CBD (MEFP ¶35, TMU ¶53) 2/	0	0	0	0	0	0	0
VI.	Floor on currency board cover (MEFP ¶12, ¶18, TMU ¶54) 7/ 2/	116	105	105	105	105	105	105
Quantitative benchmarks								
I.	Ceiling on the wage bill (MEFP ¶13, ¶22, TMU ¶55) 8/	11,545	9,500	12,081	3,500	6,750	10,000	
Memorandum items:								
	External budgetary grants	0	500	1,673	1,673	500	750	
	External budgetary loans	0	500	2,090	2,090	1,000	1,500	
	Externally financed public investment	11,499	7,000	12,885	12,885	9,000	14,000	

1/ Arrears on the wage bill and to private suppliers, public enterprises, and pension funds.

2/ Continuous performance criterion.

3/ Excluding arrears toward Paris Club lenders under renegotiation.

4/ Includes arrears on direct and guaranteed debt, including arrears to Italy and Spain that would benefit from Paris Club rescheduling terms.

5/ Performance criterion to be met by September 17, 2008.

6/ Excluding IMF and AMF counterpart funds and treasury bills that might be issued for liquidity management purposes.

7/ Gross foreign assets of the BCD in percent of monetary liabilities (reserve money plus government deposits at BCD).

8/ Excluding wages, housing subsidies, and other in-kind benefits of education and health employees.

Table 2. Djibouti: Performance Criteria and Structural Benchmarks for the First Year of the Program Supported by the PRGF

I. Structural Performance Criteria

• VAT: Submit the draft VAT Law to the National Assembly, with a single general rate set at 7 percent and implementation to begin with the 2009 budget (MEFP ¶19).	End-November 2008
• Liquidity management: Strengthen monetary control by introducing reserve requirements with respect to deposits (MEFP ¶29).	End-August 2009

II. Structural Benchmarks

• Tax administration: Revise the Investment Code to streamline tax exemptions (duration of exemptions, list of tax benefits) and strengthen the procedures and resources for monitoring exempt projects (MEFP ¶20).	End-February 2009
• Budget and expenditure management: Introduce a single Treasury account (MEFP ¶21, TMU ¶57).	End-May 2009
• Banking supervision: Conduct full on-site inspections of at least three banking institutions (MEFP ¶31).	End-August 2009
• AML/CFT: Increase the staffing of the Financial Intelligence Unit (FIU), its resources, and its independence, to enable it to carry out its mission properly, taking account of the recommendations of the AML/CFT mission of the IMF Legal Department (MEFP ¶32).	End-August 2009
• Competitiveness and energy cost: Reorganize and adjust the provision of human resources to the EDD so as to reduce personnel costs, in accordance with the results of a study to be undertaken by an independent, specialized international firm regarding the scope of this adjustment, with plans for early retirement and the redeployment of excess employees to other short-staffed public utilities. The report and recommendations will be concluded by end-August 2009, and a progress report on the study will be produced by end-February 2009 (MEFP ¶38).	End-August 2009
• Competitiveness and private sector investment: Submit the new Commercial Code, prepared with the assistance of the European Union, to the National Assembly (MEFP ¶37).	End-November 2008
• National accounts: Conduct a survey of economic activities with a view to including its results in the estimates of the national accounts, with the support of our development partners (MEFP ¶42).	End-August 2009
• Transparency: Publish: (i) the audited accounts of the social security funds and of the principal public enterprises, within nine months of year-end; (ii) the TOFE within 60 days of each month-end; and (iii) preliminary year-end budget execution data, within five months of the end of the year (MEFP ¶25, TMU ¶56).	Continuous

ATTACHMENT II TO LOI. TECHNICAL MEMORANDUM OF UNDERSTANDING

48. This memorandum defines the quantitative performance criteria and benchmarks for the new program supported by the Poverty Reduction and Growth Facility (PRGF), described in Tables 1 and 2 of the pertinent Memorandum on Economic and Financial Policies (MEFP). It also establishes the scope and frequency of data to be provided for program monitoring purposes. Government (the authorities or the government) is defined only as the central government, excluding the social security system.

49. Structural performance criteria and structural benchmarks are established for end-August 2008, end-February 2009, and end-August 2009, while quantitative performance criteria are set for end-December 2008 and end-June 2009. By performance criteria (ceilings and floors) and indicative targets, we mean the cumulative changes that have occurred between the beginning of the calendar year and the end of the month of reporting. Certain floors and ceilings are adjusted by the cumulative gaps between flows of external financing (grants and loans) and the projections, converted at respective projected exchange rates.

PERFORMANCE CRITERIA

50. **Domestic arrears** are defined as payments falling due (principal or interest) on the domestic debt or on obligations contracted or guaranteed by the central government or the CBD. The ceiling on accumulation of new domestic arrears should be met on a continuous basis.

51. **External arrears** are defined as the stock of external arrears on debt contracted or guaranteed by the central government or the CBD, excluding debt subject to rescheduling or cancellation. This performance criterion is applied continuously. The ceiling on accumulation of new external arrears should be met on a continuous basis.

52. **Net credit to the government from the banking system** is defined as the sum of net banking and nonbanking financing of the government, namely, claims on the government minus government deposits with the financial system. Claims on the government will not include IMF and AMF counterpart funds. Treasury bills and similar financial instruments that may be issued solely for liquidity management purposes will be excluded from claims on the government.

53. **Medium- and long-term nonconcessional external debt contracted or guaranteed by the government and the CBD** includes foreign currency-denominated debt, of maturities of one year or longer, contracted or guaranteed by the government or the CBD with a grant component (discount NPV in relation to of the nominal value) of less than 35 percent, based on discount rates specific to the currency and the maturity as announced by the OECD (benchmark commercial interest rates). This performance criterion applies not only to debt as defined in point 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision 12274-(00/85) of August 24, 2000), but also to commitments contracted or

guaranteed for which value has not been received. The ceiling on new medium- and long-term nonconcessional loans contracted or guaranteed by the central government or by the CBD should be met on a continuous basis.

54. **Currency board coverage.** Gross foreign assets of the CBD are defined as the value of the external assets of the CBD, including: (a) monetary gold; (b) SDR assets; (c) the reserve position in the IMF; (d) foreign currency holdings; and (e) claims on nonresidents, such as deposits abroad. The foreign assets of the CBD exclude assets that are committed or otherwise encumbered, including but without being limited to assets used as collateral or guarantee for foreign liabilities of third parties (assets not immediately available). For the purposes of monitoring performance compared with currency board coverage, the effects of valuation on the stock of gold holdings will be excluded, and gold holdings will be valued at the gold price in effect on December 31, 2007. Similarly, the U.S. dollar value of the gross international reserves will be converted into Djibouti francs at the exchange rate of US\$1=DF 177.721. Defined thus, the official reserves totaled US\$130 million at December 31, 2007. The exchange rate for the SDR and for currencies other than the dollar will be maintained at their end-December 2007 level as published in *IFS*. All the required adjustments will be calculated at the exchange rates in the program. For program purposes, currency board coverage is defined as the gross foreign assets of the CBD divided by the sum of government deposits at the CBD and reserve money. The floor on currency board cover should be met on a continuous basis.

QUANTITATIVE BENCHMARKS

55. **Wage bill.** The ceiling on the wage bill includes all gross salaries, wages, allowances, benefits, and payments, including housing assistance, that the government agrees to pay to civil servants and to military and security personnel (whether permanent or temporary) and to all other government employees except personnel of the Ministries of Education (including housing assistance) and Health, regardless of the means of payment used (cash, check, or other instruments) or the payment agent (the Treasury or another agency acting on behalf of the government).

STRUCTURAL PERFORMANCE CRITERIA

56. **Reserve requirements** will be applied to commercial bank deposits. The reserve ratio, remuneration, type of deposits subject to reserves and other characteristics of this instrument will be defined after consultation with the local banks and in agreement IMF staff.

STRUCTURAL BENCHMARKS

57. **Transparency/Reporting.** The fiscal reporting table (TOFE), the year-end budget execution data, and the audited accounts of the social security funds and principal public enterprises will be published, within the scheduled periods, on the Web page of the MEFPP or in the *Bulletin d'Information Économique* (Economic Survey). The social security funds

consist of the National Social Security Fund (CNSS) and the Military Retirement Fund (CMR), and the principal public enterprises include the national electricity company (EDD), the national water authority (ONEAD) and the national telecommunications company (Djibouti-Telecom). The audited accounts will include the balance sheet, income statement, flow of funds, and auditors' notes. The year-end budget execution data would include a breakdown by category, thus facilitating identification of all the pertinent subcategories of revenue, expenditure, and financing (including direct, indirect, and other taxes; grants; wages; goods and services; investments, etc.).

58. **Single Treasury account.** Introduce a single Treasury account. Close the various Treasury accounts at the CBD, except for accounts 1540 (principal current account) and 1539 (government compensation fund - EIC); consolidate their balances in the principal account 1540, and create subaccounts for operations such as those covered by the wage-earners account and the Office of the President account; if necessary, amend the banking regulations to allow for the opening of subaccounts.

PROGRAM ADJUSTMENT COMPONENTS

59. **Gross foreign assets and the targets for net claims on the government and for the reduction of domestic payment arrears** are defined on the basis of the assumed projected cumulative amounts for external debt service payments in cash, program-related financing (loans and grants), and the income of military bases.

60. In cases where the **total of the external debt service payments** (due date basis) exceeds (does not meet) the target for net claims on the government, the gross foreign assets of the CBD will be lowered (raised), and the ceiling on net claims on the government will be raised (lowered) by the amount of any surplus (deficit) compared with the target. By law, net claims on the government cannot be negative. Accordingly, in the event that the required adjustment were such that the total external debt service payments did not allow for this obligation to be met, leading to a negative net claims on the government figure, the difference will be applied to lowering the domestic payment arrears reduction target.

61. In cases where **government external debt service payments in cash** exceed (do not meet) the target, the net claims on the government ceiling will be raised (lowered) by the amount of the surplus (deficit) compared with the target. Net claims on the government will also be lowered (raised) by the amount of any surplus (deficit) compared with the 2007 French or U.S. payments related to the use of military bases. When net claims on the government are negative following these adjustments, the difference will be applied to lowering the domestic payment arrears reduction target.

62. In cases where the **financing of grants and loans in budgetary assistance** exceeds (does not meet) the program target, the net claims on the government ceiling will be lowered (raised) by one-half of the surplus (deficit) compared with the target. When net claims on the

government are negative following these adjustments, one-half of the difference will be applied to lowering the domestic payment arrears reduction target.

63. In the event that the **nonreschedulable arrears to Paris Club creditors are settled at end-August 2008**, the net claims on the government ceiling will be lowered by the amount of the payment made. If, following these adjustments, net claims on the government are negative, the difference will be applied to lowering the domestic payment arrears reduction target.

REPORTING OBLIGATIONS

64. The authorities will provide the IMF with all statistical, economic, and financial data necessary for monitoring economic developments and the results of the program, including but without being limited to the specific information below.

65. The CBD will provide the IMF with the balance sheet of the central bank, the consolidated balance sheet of the commercial banks, and the monetary survey, within four weeks of the end of the reporting period (the end of each month).

66. The consumer price index, within four weeks of each month-end.

67. The monthly fiscal reporting table (TOFE) data on operations, revenue, expenditure, and budget financing items, including data on capital budget execution, with details on the externally financed portion and the counterpart funds of the central government for which donor terms apply. For the expenditure category, data should be provided on the commitment, payment authorization, payment, and balance. These data will be provided within 60 days of each month-end.

68. Domestic arrears data related to: (1) the current year, and (2) the stock at the end of the previous year; consolidated data for (1) and (2) will be reported monthly, within no more than four weeks.

69. External arrears data related to: (1) the current year, and (2) the stock at the end of the previous year; consolidated data for (1) and (2) will be reported monthly, within no more than four weeks.

70. Monthly data on foreign grants and loans received by the government and by public enterprises, by creditor and by disbursement currency, within four weeks of each month-end.

71. Monthly data on the evolution of external debt, including arrears and rescheduling operations, within six weeks of each month-end.

72. A monthly list of medium- and long-term external loans contracted and guaranteed by the government for each month, with the following details on each loan: the creditor, the

borrower, the amount, the currency, the maturity, the grace period, and the interest rate arrangements. These data will be reported within four weeks of each month-end.

73. Quarterly data on the balance of the external debt stock, by creditor, debtor, and currency, within six weeks of the end of each quarter.

74. Half-yearly data on “social spending (education, health, and housing),” with details on wages, salaries, and benefits, within no more than six weeks of the end of each quarter; and

75. Quarterly balance of payments statistics, within one quarter of the end of the third quarter of 2008.

76. Any revision of data reported previously will be quickly forwarded to the staff with appropriate explanations.