 July 2009

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Djibouti: 2008 Article IV Consultation and Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility—Staff Report; Staff Statement; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Djibouti

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the combined discussion of the 2008 Article IV consultation and the first review under the three-year arrangement under the Poverty Reduction and Growth Facility, the following documents have been released and are included in this package:

- The staff report for the combined 2009 Article IV consultation and First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, prepared by a staff team of the IMF, following discussions that ended on June 24, 2008, with the officials of Djibouti on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 4, 2008. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff statement of September 17, 2008, updating information on recent developments.
- A Public Information Notice (PIN) and Press Release summarizing the views of the Executive Board as expressed during its September 17, 2008, discussion of the staff report on issues related to the Article IV consultation and the review, respectively.
- A statement by the Executive Director for Djibouti.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Djibouti*
Memorandum on Economic and Financial Policies by the Authorties of Djibouti*
Technical Memorandum of Understanding*
*Also be included in Staff Report.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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DJIBOUTI

Staff Report for the 2008 Article IV Consultation and Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility

Prepared by the Middle East and Central Asia Department
(In consultation with other departments)

Approved by Amor Tahari and Patricia Alonso-Gamo

September 4, 2008

- Discussions for the 2008 Article IV consultation and on a program to be supported by an arrangement under the Poverty Reduction and Growth Facility (PRGF) were held in Djibouti during March 15–29, 2008 and June 14–24, 2008. The staff team comprised Messrs. Delgado (head), Dridi, Iradian, Pani, Mrs. Beidas-Strom (all MCD), and Mr. de Schaetzen (SPR). Mmes. Rice and Mbea (TGS) provided interpretation services, and Ms. Amon (MCD) provided administrative assistance.

- The mission met with the Central Bank of Djibouti (CBD) governor; ministers of finance and energy; senior government officials; and representatives of the private sector and the donor community.

- The authorities are requesting a three-year PRGF arrangement for SDR 12.72 million (80 percent of quota) in support of a program covering the period September 2008–August 2011. Djibouti's outstanding purchases and loans from the Fund were SDR 8.81 million (55.4 percent of quota) at the end of June 2008.

- The previous consultation was concluded on April 27, 2007. The staff report is available at http://www.imf.org/external/pubs/cat/longres.cfm?sk=20985.0

- Djibouti has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on payments and transfers for current international transactions.

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EXECUTIVE SUMMARY

The discussions and the proposed program focused on debt and fiscal sustainability in a poverty reduction context, exchange rate alignment, financial sector issues, and structural reforms to improve competitiveness and broaden economic growth.

Background. Economic growth accelerated in 2007, driven by large foreign direct investment (FDI) inflows. Inflationary pressures intensified, mainly due to higher food and oil prices. Fiscal policy continued to be expansionary. The external current account deficit widened significantly, mainly on account of imports of capital goods and services linked to FDI. Large capital inflows financed the external position. External competitiveness improved through further real effective depreciation of the Djibouti franc and implementation of structural reforms.

Authorities' views

- **Economic growth** will continue to be based on the ability to attract large FDI flows. To expand growth beyond an enclave around the port and other large projects, the authorities are implementing social policies targeting education and health, and are strengthening the regulatory framework for the development of the private sector. **Inflation** is being fought mainly by establishing limits on commercial margins and eliminating taxes on basic food items.
- **Fiscal policy** is anchored in the medium-term objectives of balancing the budget while increasing poverty reducing expenditures. The 2008 budget law provides for the introduction of a value-added tax (VAT) in 2009.
- **The financial sector** is rapidly expanding. The authorities are aware of the need to strengthen the regulatory and supervisory framework, and look forward to the recommendations of the forthcoming Financial Sector Assessment Program.
- **The exchange rate** system has long provided stability for the country. The authorities see merit in maintaining the currency board arrangement at an unchanged parity. **Competitiveness** would improve through structural reforms aimed at increasing productivity and reducing costs, including by restructuring the main public utilities.

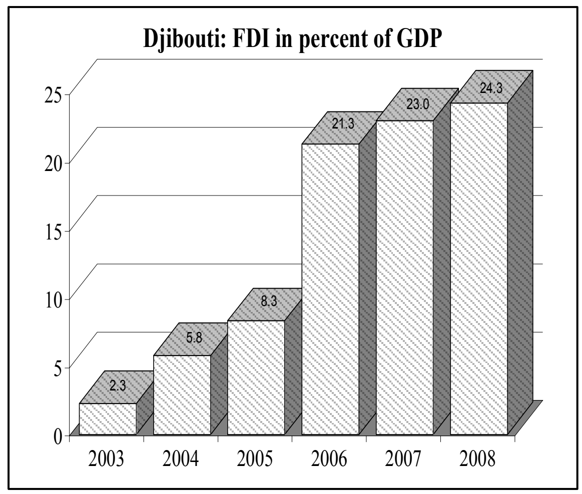
Staff recommendations

- **Fiscal consolidation** is critical to improve sustainability and finance the poverty reduction strategy. This requires actions to broaden the tax base and to contain current expenditure.
- **The exchange rate** is broadly in line with fundamentals. The staff concurs with maintaining the currency board arrangement at an unchanged parity, and urges the authorities to speed up the implementation of fiscal and structural measures to address the **competitiveness** problem. Streamlining the utilities sector and strengthening the labor market and commercial transactions regulatory framework would also increase productivity and contain **inflation**.
- Staff supports the authorities' request for a **new three-year Poverty Reduction and Growth Facility (PRGF)**. The design of the PRGF-supported program is aligned with the authorities' poverty reduction strategy, and aims at creating fiscal space to finance poverty reduction expenditures while consolidating the fiscal position and accelerating structural reforms.

I. Background

1. **The political situation remains stable, despite renewed tension at the border with Eritrea.** President Guelleh was reelected in 2005 for a second six-year term. The ruling party's coalition won all seats in the February 2008 parliamentary elections as the opposition boycotted the polls. The prime minister and the minister of finance were reappointed to the new cabinet formed in March 2008. Renewed stress in the relations with Eritrea resulted in troop deployments and, in June 2008, border clashes resulting in several casualties. Nevertheless, the risk of escalation appears limited and a prompt and peaceful resolution is likely.

2. **The 2008 Article IV consultation and program discussions were held against the backdrop of growing economic activity and improved prospects following large inflows of foreign direct investment** (FDI). Djibouti's political stability and strategic location on the horn of Africa along major shipping routes attracted about US$360 million of investments in the port construction and related infrastructure over the period 2006–07, transforming Djibouti into a nascent regional trade and financial hub. The challenge is to ensure that growth does not remain limited to an enclave around the port. So far, the highly capital-intensive FDI projects have provided only limited employment opportunities and the development of an export sector is hampered by the high domestic cost of inputs.



3. **The authorities have elaborated a new poverty reduction strategy (PRS) and are requesting a new Poverty Reduction and Growth Facility (PRGF) arrangement to support it.** The new PRS is critical for anchoring the reform program and unlocking donor support, spreading the benefits of growth by encouraging private sector development. A detailed account of the PRS is contained in the new Poverty Reduction Strategy Paper (PRSP) prepared with the assistance of World Bank and IMF staff, which has been published on the website of the Ministry of Finance (MoF).[1] A new Fund-supported program would lend credibility to the PRS, anchor it in a stable macroeconomic framework, help expand the institutional and technical capacity for its implementation, and help close the financing gap exacerbated by the food and oil price shocks. To mobilize the support of their development partners, the authorities intend to hold a donors' conference in November 2008. Limited available data indicates that progress toward achieving the Millennium Development Goals (MDG) remains limited, notwithstanding the advances made in improving education, reducing child mortality, and developing a comprehensive national strategy to combat HIV/AIDS and other diseases.

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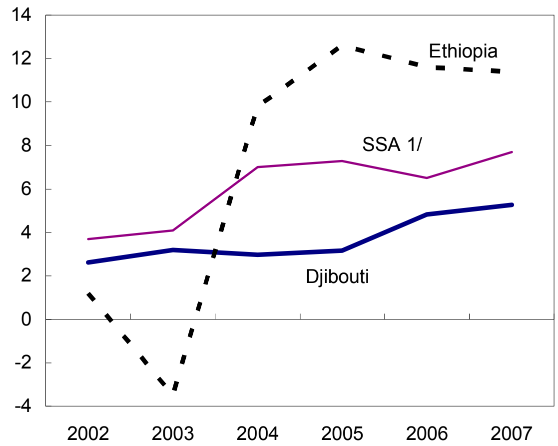
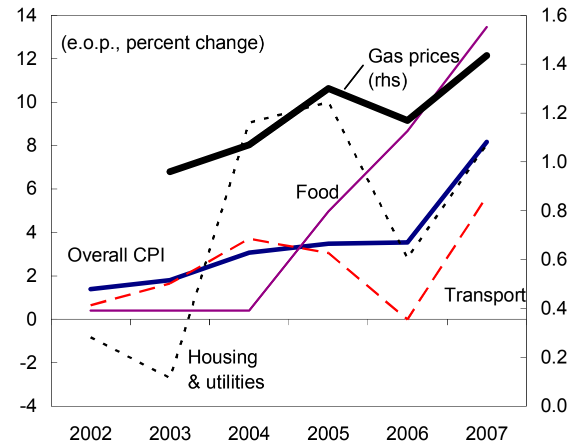
[1] The PRSP and corresponding JSAN will be issued to the Board at a later date.

Figure 1. Djibouti: Selected Economic and Financial Developments

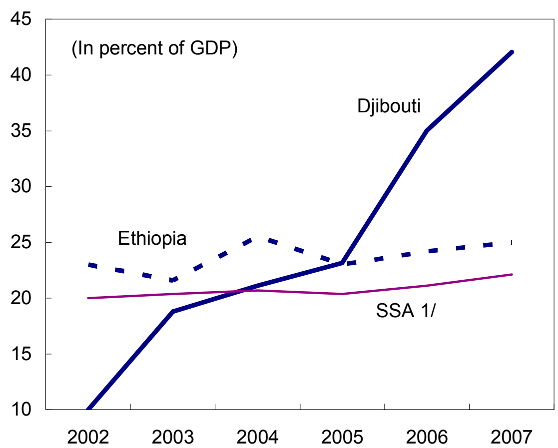
Real GDP growth in Djibouti accelerated, but remained below the average for sub-Saharan Africa



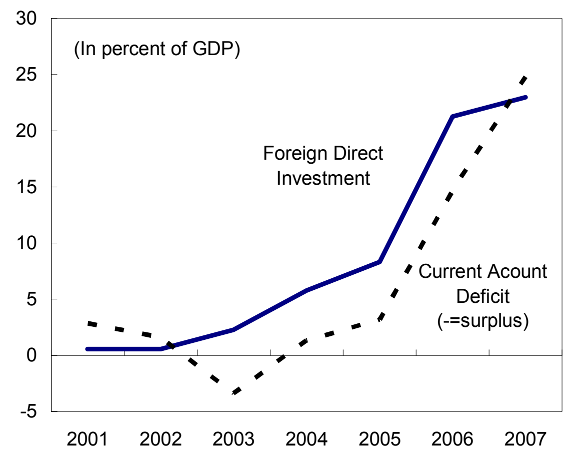
Inflation increased due mainly to higher import prices of food and energy



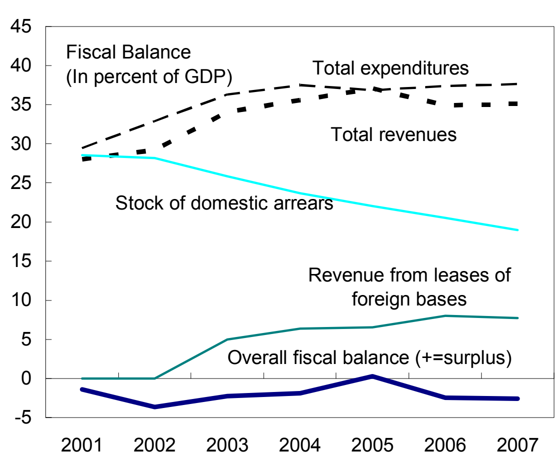
Investment in Djibouti is much higher than most sub-Saharan African economies...



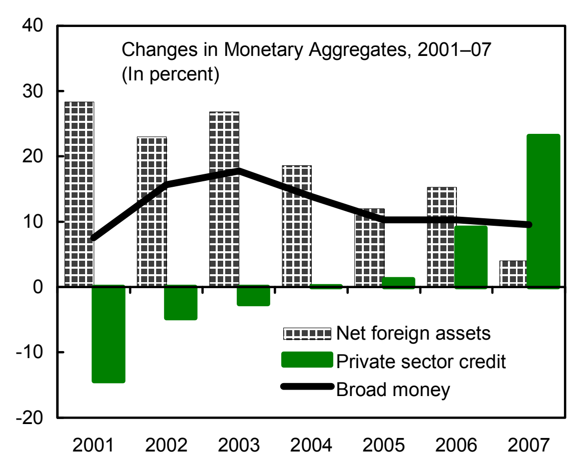
... leading to the widening of the external current account deficit, but largely financed by FDI



Fiscal stance continued to be expansionary and domestic arrears, while declining, remained high



The pick up in economic activity is supported by an increase in credit to the private sector.



1/ Sub-Saharan Africa excluding South Africa and oil-exporting SSA economies.

4. **Since 1990, Djibouti has had two Fund-supported programs and two staff-monitored programs** (SMPs). Under the 1996–99 Stand-By Arrangement, progress was made in reducing macroeconomic imbalances. Under the 1999–2002 PRGF, tax and pension reforms advanced, but progress was limited in adopting structural reforms to improve external competitiveness. Only one review was completed under the one-year SMP in 2004 as the government was unable to maintain fiscal discipline or implement the reform agenda against the backdrop of a presidential election period. Quantitative fiscal targets under the July–December 2005 SMP were largely met, and all key structural benchmarks have now been met.

II. Recent Economic Developments

5. **Macroeconomic performance improved significantly, but inflationary pressure is intensifying.** Despite a substantial acceleration of economic growth, Djibouti still lags behind the average of sub-Saharan Africa (SSA). Real GDP growth accelerated from 4.8 percent in 2006 to 5.3 percent in 2007 (Table 1), driven mainly by FDI concentrated in the construction and port services sectors. The share of investment in GDP grew from 23 percent in 2005 to about 42 percent in 2007 (of which slightly more than half is in the form of FDI). This rapid expansion, combined with the surge in food and oil import prices, pushed inflation from 3.5 percent in 2006 to 13.9 percent year-on-year in June 2008. In response, the authorities have eliminated consumption taxes on five basic food items, and reached agreement with importers and retailers to cap their profit margins on these and other basic items.

Djibouti and Sub-Saharan Africa (SSA): Selected Economic Indicators 1/

	2001	2002	2003	2004	2005	2006	2007	2005–07	
	Djibouti							Djibouti	SSA 1/
	(Percent change)								
Real GDP	2.0	2.6	3.2	3.0	3.2	4.8	5.3	4.4	5.9
CPI (end-of-period)	1.8	0.6	1.8	3.1	3.5	3.5	8.2	5.1	9.0
	(Percent of GDP)								
Private sector credit	25	23	22	21	20	20	22	20	16
Fiscal expenditure	29	33	36	37	37	37	38	37	25
Overall fiscal balance	-1.4	-3.7	-2.3	-1.9	0.2	-2.5	-2.6	-1.6	-0.2
FDI	0.5	1	2	6	8	21	23	18	4
Total investment	9	12	19	21	23	35	42	33	23
External public debt	49	57	66	68	60	52	51	54	51

Sources: National authorities; and Fund staff estimates.
1/ SSA: Sub-Saharan Africa excluding South Africa, Zimbabwe, and oil-exporting SSA countries.

6. **Fiscal policy remained expansionary.** The overall deficit remained at about 2.5 percent of GDP in 2007, even as the basic fiscal deficit (which excludes externally financed revenue and expenditure) narrowed from 7.2 percent in 2006 to 4.9 percent in 2007 (Table 2). Tax revenue declined by about 1 percent of GDP, as a result of tax exemptions granted to new investments and sluggish job creation. This decline was offset by an exceptional collection of overdue taxes, largely from the Electricity Company (EDD). Current expenditure declined from 30 percent of GDP in 2006 to about 26.5 percent in 2007, reflecting the non-recurrence of extraordinary outlays in 2006 associated with the regional elections and the Common Market for Eastern and Southern Africa (COMESA) summit. Thus, the slight rise in the overall deficit in 2007 is explained by the large increase (3.7 percent of GDP) in public investment. Most non-Paris Club government external arrears outstanding at end-2006 have been repaid, but the transitory accumulation of new arrears to multilateral official creditors led to disbursement delays of some loans.[2] Preliminary information indicates that new external arrears, including with multilateral official creditors, have accumulated during the first half of 2008. External public and publicly guaranteed debt remained at about 60 percent of GDP.

7. **After remaining stagnant for several years, credit to the private sector increased by 23 percent in 2007** (Table 4), owing in part to a real estate and construction boom and competition from recently established foreign banks. Broad money growth slowed down to 9.6 percent as the surge in credit was compensated by a lower accumulation of banks' foreign assets. Banking soundness ratios remain well above regulatory requirements. The capital adequacy ratio fell from 17.4 to 8.1 percent at end-2007 (Table 11), reflecting the entrance of three new banks. Asset quality has improved through the reduction of nonperforming loans and the increase in the loan portfolio. Profitability remained high, despite increased competition. Greater confidence in the currency board and in the banking system has also led to a decrease in dollarization from 52.4 percent of total bank liabilities in 2006 to 51.4 percent in 2007, reducing financial vulnerability. The arrival of three new foreign banks in 2006–07, increasing the number of institutions from two to five, has fostered competition by reducing interest rate spreads and increasing the range of financial instruments (Box 1).

Djibouti: Selected Banking Sector Indicators

(In percent)	2004	2005	2006	2007
Total capital to risk weighted assets	101.5	106.2	102.7	91.0
Non-performing loans to gross loans	28.8	27.8	24.5	17.8
Provisions to non-performing loans	55.1	56.6	57.4	56.5
Return on assets	2.1	1.9	1.8	1.8
Return on equity	21.1	28.2	41.8	40.1
Liquid assets to total assets	74.3	76.6	75.4	72.1
Liquid assets to total deposits	85.4	87.7	89.1	87.1

Sources: Central Bank of Djibouti; and Fund staff estimates.

[2] See Appendix I ¶53.

Box 1. Reform of the Financial Sector

Djibouti's financial system is dominated by a banking sector characterized, until recently, by a very narrow focus on short-term trade operations, that did not provide an adequate basis for the development of the private sector. As a consequence, financial intermediation remains weak as reflected in the relatively low level of credit to the private sector as a percent of GDP. High market concentration (two banks account for 95 percent of the country's total assets), weak enforcement of creditor rights, and the absence of comprehensive information on borrowers, keep lending risks high.

Djibouti: Comparative Banking Sector Performance

	Broad Money (In percent of GDP)		Credit to Private Sector (In percent of GDP)		Cash in Percent of Deposits		Interest Rate Spreads 1/ (In percent)	
	2000	2007	2000	2007	2000	2007	2000	2007
Djibouti 2/	53	78	32	22	21	15	10.5	8.4
Egypt	75	90	52	46	17	16	3.8	6.4
Ethiopia	35	33	18	21	25	26	4.5	4.0
Ghana	27	37	14	24	59	34	17.0	16.6
Kenya	37	39	26	24	15	14	14.2	8.2
Morocco	73	105	51	70	25	23	17.2	9.7
Senegal	24	37	19	23	28	35	6.6	5.0
Yemen, Rep.	30	37	5	8	80	52	5.5	5.0

Source: *International Financial Statistics* (IMF).
1/ Lending minus deposit rates (percent per annum).
2/ Broad money is likely to include unquantified non-resident deposits.

The entrance of three new banks in the past two years, however, has increased competition among banks, resulting in lower intermediation spreads and new banking services. The authorities are closely working with banks to expand their range of financial products and services (such as automated teller machines, Islamic products, and products for small and medium-size enterprises). A shift has already occurred away from short-term foreign trade financing instruments to the incipient development of a mortgage market, linked to the recent real estate and construction boom. This renewed competition largely accounts for the 10 percent annual growth in deposits at end-2007, prompted by the authorities' efforts to increase bancarization by reaching new customers via innovative products, and to attract depositors from neighboring countries to develop a regional financial hub.

New Banks Operational as of 2007 or to Start Operations in 2008

Bank	Operating Since	Scheduled for 2008	Origin	Shareholding
• SABA Islamic Bank(SIB)	6/25/2006		Yemen	Yemeni (85 percent) with Dubai Islamic Bank (15 percent)
• International Commercial Bank (ICB)	9/4/2006		Malaysia	Malaysian (100 percent)
• Banque de Dépôt et de Crédit de Djibouti	12/22/2007		Switzerland	Majority Swiss, Djibouti (24 percent)
• Cooperative and Agricultural Credit Bank (CAC Bank)		Yes	Yemen	Yemeni (90 percent) and Saudi Arabian (10 percent)
• Al-Zumorrodah African Bank		Yes	Kuwait	Kuwait (100 percent)
• Islamic Bank of East Africa		Yes	International	Somalian (38 percent), Djiboutian (30 percent), others (including Canadian, Norwegian, and Swedish (32 percent))

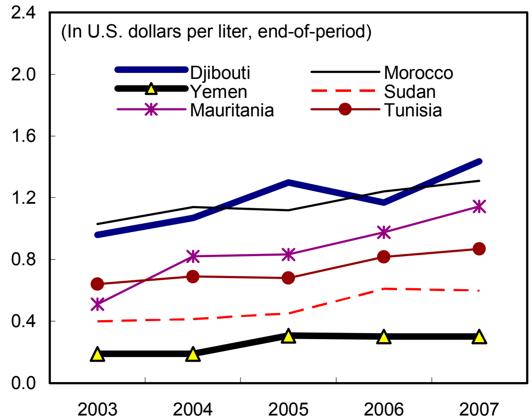
The banking system's growing size and range of instruments has also raised the bar for the Central Bank of Djibouti's (CBD) regulatory and supervisory resources and standards. In the coming months, the number of banks expected to operate in Djibouti will increase to eight, with very diverse capital origins and regulatory structures. Furthermore, unlike the previous situation, in which the CBD could entrust the supervisory authorities from the parent institution (France) to oversee the global operations of the only two financial groups operating in the country, some of the new institutions do not have strong home supervisory and regulatory agencies.

The microfinance sector remains at an embryonic stage. The Poverty Reduction Strategy (PRS) places great emphasis on building the capacity of micro-credit associations, to be transformed into genuine microfinance institutions (MFIs). The MFIs are expected to develop a range of new services including micro-insurance and micro-transfers, which will significantly boost household access to microfinance (currently only 4 percent of the population benefits from microcredit).

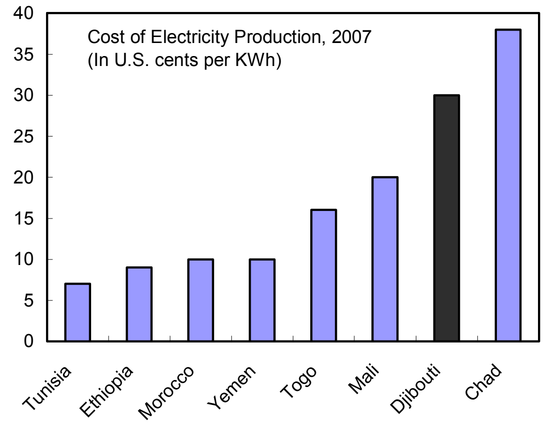
Figure 2. Djibouti: Competitiveness Indicators

Djibouti: competitiveness remains poor...

Domestic gas prices are high even when compared to oil importing countries.

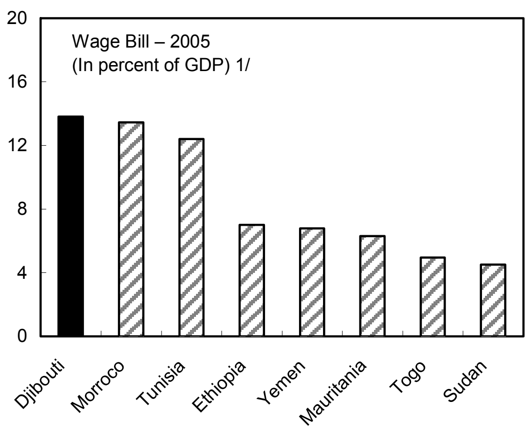


Cost of electricity production is among the highest in the world.



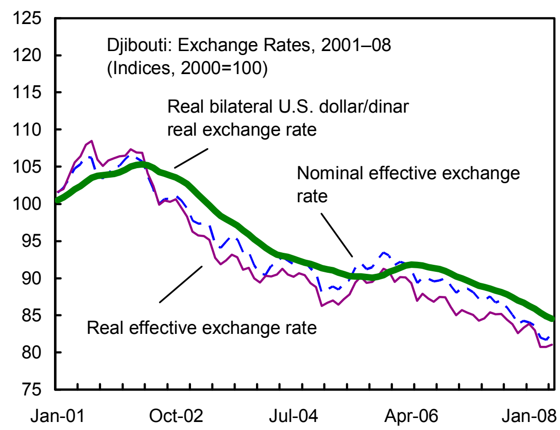
…but it is improving.

Wage bill in Djibouti is one of the highest among developing countries.

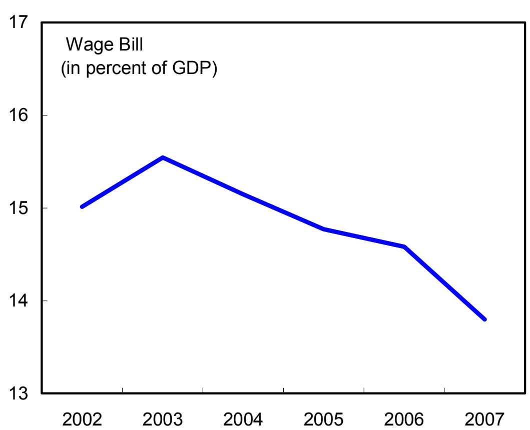


1/ 2005 data except for Djibouti (2007).

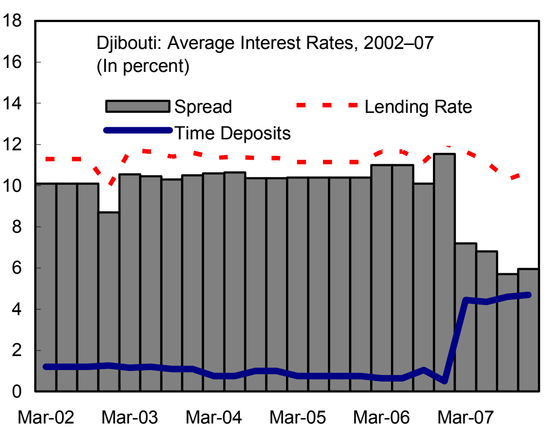
With the weakening of the U.S. dollar,



through wage constraints...



…and increase in competition in the financial sector.



Sources: National authorities; and Fund staff estimates.

8. **The widening current account deficit reflects mainly a surge in imports financed by foreign investment, but also the increase in food and oil prices.** The external current account shifted from a small surplus in 2003 to a deficit of about 25 percent of GDP in 2007 (Table 3), but this has been more than offset by the large capital and financial account surplus, resulting in a small increase in gross official reserves to US$130 million at end-2007 (equivalent to a currency board cover of 116 percent). This increase, however, lagged behind imports, thus resulting in a reduction of the import cover to less than two months. The real effective exchange rate (REER) has depreciated by a cumulative of 24 percent in 2001–07, relative to its 2000 average, reflecting mainly the weakening of the U.S. dollar. Nevertheless, a variety of indicators suggest that competitiveness remains low. Electricity, labor, and other domestic production costs are high, while skill level is low, and the institutional environment is weak.

9. **Significant progress has been made in implementing structural reforms.** A new Labor Code came into force in 2006, a physical audit of the civil service was completed in 2007, the three key pending structural benchmarks of the SMP were completed (see Table 9), and a PRSP was prepared with assistance from World Bank and IMF staff. In particular, reform of the civil service has advanced with the completion of the physical audit and by the recent establishment of a single registry of civil servants. An assessment of the anti-money laundering and combating the financing of terrorism (AML/FT) system was conducted by the Fund's Legal Department (LEG) in 2007, in the context of a forthcoming Financial Sector Assessment Program (FSAP). The authorities have started to reform the social safety system, by merging two of the three pension funds in January 2008. In the area of statistics, the Fund's Statistics Department (STA) provided technical assistance (TA) to improve balance of payments and monetary statistics, while the Fund's Monetary and Capital Markets Department (MCM) provided TA to implement the International Financial Reporting Standards (IFRS) at the CBD**.**

Competitiveness: Djibouti Versus Fast Growing and Comparator Economies, 2007

	REER (2000=100)	FDI Stock as Percent of GDP	Government Consumption as Percent of GDP	Electricity Prices (2006) 1/ (U.S. cents/kwh)	Education 2/	Quality of Institutions 3/	Ease of Doing Business 4/
Chad	117	7	9	38	10	7	173
Djibouti	84	36	25	30	23	25	146
Ethiopia	106	27	12	9	28	24	102
Mali	109	19	17	10	20	44	158
Morocco	93	3	18	10	35	44	129
Sudan	151	6	15	...	19	6	143
Tunisia	82	71	16	8	68	53	88
Yemen	139	7	14	10	40	20	113

Sources: IMF *World Economic Outlook* and World Bank's databases,and UNCTAD *World Investment Report*, 2007.
1/ IMF staff reports and International Energy Agency, Energy Statistics, 2007 Edition.
2/ Net secondary school enrollment rate as percent of age group.
3/ Average of voice and accountability, political stability, government effectiveness, regulatory burden, rule of law and control of corruption. The scores lie between 0 and 100, with higher scores corresponding to better outcome.
4/ Rank out of 178 countries. Based on starting a business, dealing with licenses, employing workers, registering property, getting credit, protecting investors, paying taxes, trading, enforcing contracts, and closing a business.

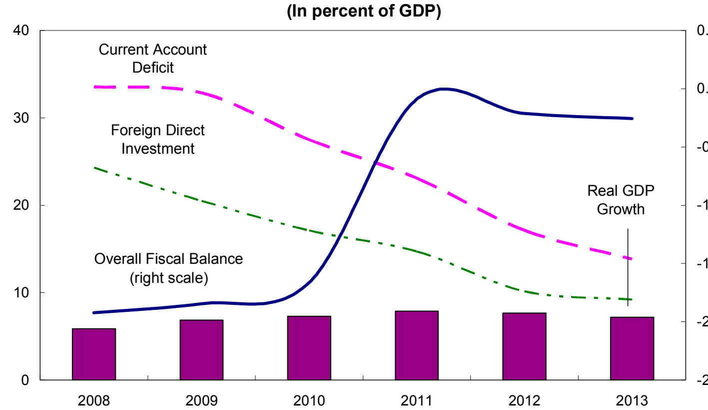
III. POLICY DISCUSSIONS

10. **The discussions focused on three key areas:** (a) debt and fiscal sustainability in a poverty reduction context; (b) financial sector issues; and (c) exchange rate alignment and the role of structural reforms to improve competitiveness and broaden economic growth. These areas, as well as issues related to strengthening institutional capacity, particularly in the area of statistics, are relevant both in the context of the Article IV consultation and the program to be supported by a PRGF arrangement.

A. Outlook and Risks

11. **Short- and medium-term growth prospects remain strong**, driven by a solid pipeline of large investment projects (Tables 5 and 8). These projects are part of the government's strategy to transform Djibouti into a regional trade and services hub, and reflect the interest of international investors in the country. Based on the authorities' medium-term policies discussed in this section (including those related to program conditionality—see Section IV.A below), the baseline scenario envisages that real GDP would increase by 5.9 percent in 2008 and by about 7 percent a year in 2009–13. Inflation is expected to be slightly above 8 percent in 2008, but would decline gradually thereafter as world food and oil prices ease. The fiscal stance would tighten substantially to reach a balanced position by 2011. After peaking at 33 percent of GDP in 2008, the current account deficit is projected to narrow gradually to about 23 percent by 2011. Since Djibouti cannot pay its external arrears and meet its financing needs, external financial assistance under the program from the Fund and donors will be essential to filling the 2008 financing gap estimated at US$37 million (2.13 percent of GDP) (Table 3). After accelerating to 35 percent in 2008 due to the low starting point, private sector credit growth will decline progressively to an average rate of about 20 percent over the medium term. While broadly agreeing with the staff's medium-term outlook, the authorities flagged the uncertainties associated with food and oil prices.

Djibouti: Short- and Medium-Term Outlook, 2008–13
(In percent of GDP)



Sources: Djibouti authorities; and Fund staff estimates.

12. **The main downside risks to this outlook relate to Djibouti's vulnerability to external economic and political shocks**. Recent increases in food and oil prices have negatively impacted the country's projected external position. The projected increase in the current account deficit will be financed only in part by projected FDI and other financial

inflows, thus weakening Djibouti's external position in the absence of additional external support. The authorities are also concerned about food security. Aside from temporary measures to limit the pass-through of international food prices to domestic consumers, the authorities are planning to diversify food imports by tapping new and less expensive external sources, and to increase domestic agricultural production by developing the rural water supply, providing credit to agriculture, and leasing agricultural land in Sudan and Ethiopia. Finally, a worsening of the security situation in Somalia or Eritrea could adversely affect Djibouti's development prospects.

B. Fiscal Policy

13. **Fiscal policy is geared toward increasing the revenue base, containing current expenditure and improving budget management, in order to release resources to finance the PRS without compromising fiscal sustainability or competitiveness.** A unified and integrated tax department at the ministry of finance, including its collection enforcement unit, has greatly improved tax administration, resulting in a surge of over 300 percent in tax recovery in 2007. In addition, the authorities intend to review the overall tax framework and streamline tax exemptions to eliminate their negative effects. In order to contain current expenditure, the authorities resisted calls to increase salaries despite mounting inflationary pressures, developed a system for the centralization of public procurement, and made progress in the civil service reform. They requested TA from the Fund's Fiscal Affairs Department (FAD) in order to strengthen their public management framework (PMF), including a reform of the budget classification system and the unification of government accounts. They also intend to strengthen fiscal transparency by increasing the range and frequency of the publication of fiscal data.

14. **The authorities intend to accelerate the repayment of outstanding arrears.** All outstanding external arrears will be cleared before consideration of the PRGF arrangement by the IMF Executive Board, while the repayment of domestic arrears will proceed according to the existing ten-year repayment plan. A large part of these arrears is owed to the public utilities companies, particularly to the EDD and the water and sewage company (ONEAD). Consequently, repayment of these debts will contribute to reestablishing these utilities' financial viability, improving their competitiveness and, eventually, reducing domestic production costs. To prevent the accumulation of new arrears, the authorities intend to improve cash management and expenditure controls and rebuild the stock of government deposits.

15. **The authorities plan to go ahead with the introduction of a value-added tax (VAT), despite the delay of the COMESA in reaching final agreement on the external common tariff (TEC).** Progress has been made in modernizing tax administration and establishing the unified integrated tax department, a critical step to support the introduction of a VAT, with technical and financial assistance from FAD, the European Union (EU), and France. Failure to agree on all categories of the TEC in the latest COMESA summit, however,

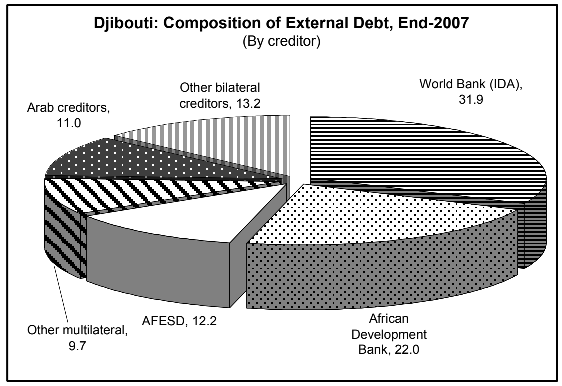
forced the authorities to change the implementation plan. Instead of introducing the TEC and VAT simultaneously, and immediately eliminating both the existing sales tax (TIC) and services tax (TPS), the VAT will be introduced starting in January 2009, coexisting with the TIC until the TEC is introduced. However, the TIC rates will be reduced to avoid a surge in the fiscal burden.

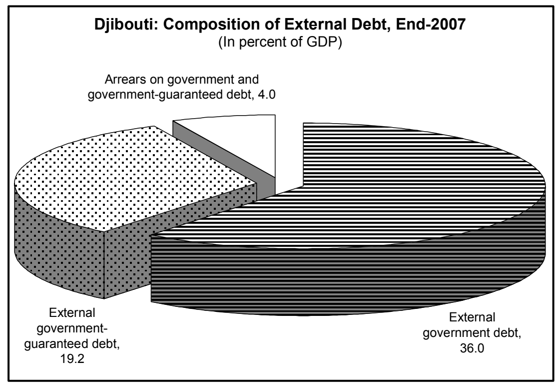
16. **The fiscal restraint objective embedded in the 2008 budget was rather ambitious**, particularly taking into account the negative effects of the food and oil price shocks. According to the budget, the overall fiscal deficit would be halved. The authorities are of the view that the prudent budget revenue targets remain achievable—even after the tax reductions on food products introduced in the first half of 2008 (estimated to cost about 0.5 percent of GDP), largely compensated by a World Bank grant. However, the budget expenditure targets would require a considerable containment effort, in view of the additional spending requirements posed by the PRS, the increase in the transfers to the EDD related to the increase in oil prices (estimated at about 1.2 percent of GDP as of end-May 2008 oil prices), and the increase in military expenditure associated with the border clashes with Eritrea. Therefore, the authorities have already revised their overall fiscal balance target deficit for 2008 to 1.9 percent of GDP. The authorities are confident in their ability to mobilize additional external financing in the form of budget support loans and grants for about 2.2 percent of GDP which might be needed to support the EDD and improve government liquidity, including through the catalytic effect of a PRGF arrangement.

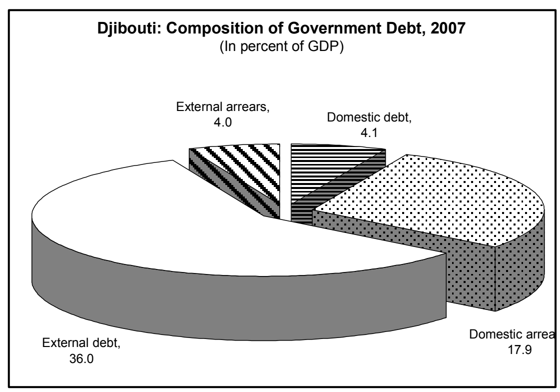
17. **The authorities concurred with the conclusions of the debt sustainability analysis carried out jointly with World Bank staff** (Box 2, Appendix I), which indicates a high risk of debt distress in the short term. They agreed that, notwithstanding the improvements in the underlying economic assumptions and the resulting debt profile, important vulnerabilities remain. These include external factors such as the worsening of financial conditions, shortfalls in projected FDI flows or a deterioration in the current account as a consequence of further food and oil price increases, as well as internal reasons, such as the triggering of contingent liabilities arising from government guarantees on external debt or the failure to implement the necessary fiscal consolidation measures.

Box 2. External Debt and Fiscal Sustainability

External and total government debt are estimated respectively at 59.3 percent and 62 percent of GDP in 2007, including arrears. After improving considerably in 2006 following a debt restructuring agreement with Italy, Djibouti's debt situation remained broadly stable in 2007. Most of the external debt portion is owed to official donors (notably the World Bank and the African Development Bank), and bilateral Arab creditors. Domestic government debt includes mainly arrears to government employees and providers, and outstanding loans to banks and to the Port of Djibouti. While most external arrears correspond to bilateral Paris Club loans, some outstanding arrears towards multilateral official creditors exist as of end-June, 2008. Since Djibouti has no access to international capital markets, there is no reported outstanding external debt or arrears against external private parties. According to the authorities' data, still to be reconciled with the creditors', Paris Club debt amounts to about $58 million, most of it owed to Italy, with smaller amounts due to Spain and France. About one-half of this debt is in arrears. Djibouti's debt to the Paris Club was rescheduled in May 2000 under "classic terms." In addition, part of the debt to Italy was swapped for social projects in 2006. The authorities are expected to negotiate a multilateral agreement with the Paris Club shortly, and to follow suit with bilateral agreements under the terms set by the multilateral agreement.







The debt sustainability analysis (DSA) indicates that Djibouti's risk of debt distress continues to be high, despite some improvement in the medium-term projections (Appendix I). The net present value (NPV) of external debt-GDP ratio remains above the sustainability threshold, in the baseline scenario, until 2017 (and occasionally thereafter), reflecting a vulnerable situation in the short term, although it improves markedly in the long term. Fiscal sustainability indicators are also projected to improve in the medium term. Revenue measures to reverse the erosion in the tax base caused by widespread exemptions, along with measures to contain current expenditure growth and the repayment of arrears, are projected to reduce the NPV of government debt from 55 percent of GDP in 2007 to about 33 percent by 2011. These ratios are projected to improve further in the long term as sustained growth, improvements in revenue collection, and a more efficient expenditure execution contain the primary deficit well below the estimated debt-stabilizing value.

The DSA illustrates the negative impact of less optimistic scenarios and negative shocks emanating from some of the major sources of vulnerability. The stress scenarios show that external sustainability remains particularly vulnerable to a worsening of external borrowing conditions, while fiscal sustainability is more sensitive to a decline in economic growth. An increase of 2 percentage points in the cost of new borrowing would cause the NPV of external debt-GDP ratio to remain well above the sustainability threshold, with an upward trend after 2020. The "high investment, low growth" scenario, which assumes a lower growth path scenario than projected in the baseline, also weakens debt sustainability, but to a lesser extent. Similarly, a temporary setback in growth in the short term could result in a much less favorable evolution of fiscal sustainability. If real GDP growth outturn in 2009 and 2010 were to be close to 1.6 percent, equivalent to its historical average less one standard deviation, the NPV of debt would eventually climb back to about 50 percent of GDP by 2028, while the debt service would increase to absorb about 20 percent of fiscal revenue.

C. Financial Sector Issues

18. **The authorities shared the staff's view on the need to introduce liquidity management instruments to mitigate the current inflationary pressures along with the gradual tightening of the fiscal stance.** Unlike other countries with currency board arrangements (CBA), the CBD has made little use of liquidity management instruments to ease the current inflationary pressures. With limited domestic financial instruments and in the absence of remuneration of deposits at the CBD, banks systematically transfer excess liquidity abroad. The rapid increase in credit in 2007 was largely financed through the mobilization of these liquid reserves, thus putting additional pressure on domestic demand and prices. The development of effective mechanisms to control liquidity is important to ensuring that structural excess liquidity does not endanger macroeconomic stability, particularly in a context of rising inflationary pressures. In this regard, the authorities concurred with the staff's recommendation to gradually introduce reserve requirements on bank deposits within the framework allowed by the Banking Law, while preserving the banking system's profitability and financing capacity.

19. **Rising inflation is a concern**. In the context of a CBA, monetary policy has very limited influence on price levels. Thus, the authorities expect to partially contain the impact of higher food and oil prices on overall CPI inflation through measures such as capping wholesale and retail food distribution margins, eliminating indirect taxes on basic food products, and maintaining administered prices of electricity and other utilities. The authorities agreed with the staff that caps on margins should only be seen as a temporary emergency measure, and that over the long term efforts to contain inflation should hinge on fiscal restraint[3] and on a marked-based response aimed at alleviating capacity constraints and spurring competition.

20. **The authorities agreed with the staff that the CBD's ability to oversee the financial sector needs to be strengthened** (Box 1), but they did not see an immediate need to restructure the banking supervision unit. The authorities look forward to the forthcoming FSAP recommendations to provide additional guidance in this area. They intend to increase the effectiveness of their AML/CFT framework by raising awareness, strengthening the Financial Intelligence Unit (FIU), and reinforcing the legal, regulatory, and operational framework.

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[3] In 2009, the fiscal impulse emanating from the pick up in social spending should have a minimal inflationary impact due to its high import content. Concurrently, given the program's wage freeze, no second round effects are expected from this impulse. During the rest of the program, the fiscal impulse becomes negative, thus contributing to reduce inflationary pressures.

D. Competitiveness and Exchange Rate Policy

21. **The authorities see considerable merit in maintaining the CBA.** They argued that the currency board has served to enhance confidence in Djibouti's currency and banks, and remains essential to attract new investment. The staff agrees that the CBA has contributed positively to fiscal restraint and macroeconomic stability, and that there is no compelling case for changing the exchange rate regime or its parity. Nonetheless, the recent food and oil price shocks necessitate additional external financial support to restore the gross official reserves coverage of the currency board and to maintain its credibility.

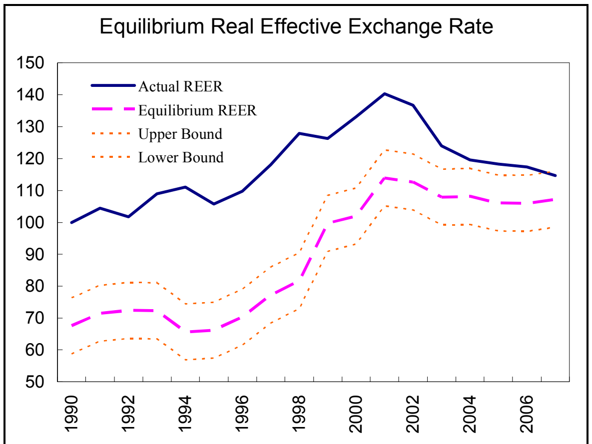
22. **Although there is no evidence of a large misalignment of the Djibouti franc (Box 3), and the recent trend shows a gradual correction of its overvaluation, several other indicators suggest that competitiveness remains poor.** The authorities agreed that this can be attributed primarily to the high costs of critical production factors (power, telecommunications, and labor), which continue to hamper private sector development. Reducing these costs, including by downsizing and improving the management of the two main loss-making public enterprises (ONEAD and EDD), will be essential to encouraging domestic and foreign investment, ensuring sustainable and balanced growth, and reducing the contingent liabilities that these enterprises pose for the budget. In the energy sector, the authorities aim to reduce costs and expand capacity by completing the interconnection with the Ethiopian power grid and developing alternative energy sources, including geothermal, solar, and wind power (Box 4). The authorities took note of the staff's suggestion to explore opportunities for the outsourcing of EDD's management to the private sector, but stressed that the successful experience with the Port of Djibouti could not be used as a guide in view of the small domestic market, weak profitability margins, and overarching social constraints that characterize the electricity sector.

23. **Enhancing competitiveness also requires improving the business climate.** The authorities have prepared a new code of commerce with the assistance of the EU, which will be submitted shortly to the National Assembly for approval. The final stages of the implementation of the labor code will be finished within one year, and the regulations and procedures that affect the cost of doing business will be simplified by further strengthening coordination among public sector agencies.

24. **The staff stressed the urgency to address data weaknesses and low implementation capacity that severely hamper economic management in Djibouti.** The authorities are working to improve the quality and timeliness of statistics on national accounts and balance of payments with the technical assistance of the Fund, the World Bank, and the United Nations Development Program (UNDP). Additional efforts are being undertaken to strengthen the poverty monitoring system and to develop a social targeting mechanism to deliver food aid. The Fund has also provided technical assistance in the areas of monetary statistics, monetary operations, banking supervision and public financial statistics.

Box 3. Exchange Rate Assessment

A variety of indicators suggest that external competitiveness in Djibouti is weak, which points to an overvaluation of the Djibouti franc (DF). The staff's exchange rate assessment confirms the existence of some overvaluation, but its quantification does not indicate that the current level of the real exchange rate is significantly out of line with fundamentals.[1]



Source: IMF staff estimate based on the CGER Methodology.

Estimates based on the equilibrium real effective exchange rate approach suggest that in 2007 the DF was slightly overvalued (in the order of 8–12 percent), which is well within the margin of error in this type of analysis. The improvement in competitiveness compared with earlier years largely reflects the weakening of the U.S. dollar, productivity gains in the port operations following new investments and the outsourcing of management to the private sector, and constrained public wage growth.

The macroeconomic balance (MB) approach indicates that the current account is close to its norm. The MB compares the projected current account deficit in 2013 of 13.8 percent of GDP (or 8.4 percent, excluding FDI-related imports) to an estimated normative equilibrium current account deficit of 12.2 percent of GDP (or 6.8 percent, excluding FDI-related imports). This implies a 7 percent overvaluation of the DF, also within the margin of error of the model.

The external sustainability (ES) approach is unsuitable in the case of Djibouti, given its rapidly changing economic structure and fast growth of FDI inflows in a context of a small country so far deprived of most natural resources and lacking an industrial productive basis. This makes it particularly difficult to estimate even an approximate sustainable equilibrium NFA position. Stabilizing the end-2007 NFA position using the Lane and Milessi-Ferretti database points to an overvaluation of 5 percent. However, it seems evident that the end-2007 NFA position is well below the equilibrium level and, therefore, the overvaluation should be above 5 percent.

Medium-term balance of payments developments and competitiveness reforms are expected to continue reducing the DF's overvaluation, although risks remain and the process could be protracted. Short-term developments—including Djibouti's vulnerability to external shocks and dependence on imports, its relatively high debt burden (and lack of debt instruments or access to financial markets), high unit labor costs, and weak NFA position (including in 2007)—point to an overvaluation of the DF. However, medium-term projections point to a self-correction of the DF's overvaluation. Export growth is projected to outpace that of imports due to new productive capacity created by the massive FDI-financed projects, the progressive decline in FDI-related imports and the substitution of imported products by local production. Also, food and oil prices are projected to ease from the peaks of 2008. However, decisive action to increase competitiveness, particularly to reduce Djibouti's high unit labor costs to a level in line with neighboring and competing countries, along with fiscal tightening (including through lower public sector labor costs) and structural reforms to reduce other production costs (particularly utilities), is indispensable to narrow the current account deficit in the medium term.

Only one (high debt risk level) out of the seven indicators identified in the 2007 Decision on Bilateral Surveillance is triggered, thus underpinning the assessment of broad alignment of the DF and its sustainability.

1/ Djibouti's exchange rate has been assessed following the IMF's Methodology for CGER Exchange rate Assessments (http://www.imf.org/external/up/pp/eng/2006/110806.pdf). This methodology has been adapted by the Middle East and Central Asia department's working group on the Assessment of Exchange Rates to fit data availability constraints and economic conditions, including whether a country is an oil importer or exporter. The Djibouti team reestimated these results using the most up to date data and projections.

2/ Lane, Philip, and Gian Maria Milesi-Ferretti, 2006, "The External Wealth of Nations Mark II: Revised and Extended Estimates of Foreign Assets and Liabilities, 1970–2004," IMF Working Paper 06/69 (Washington: International Monetary Fund).

Box 4. Electricity Cost

Electricity production in Djibouti comes at a high cost, but service delivery is poor. Despite energy tariffs amongst the highest in Africa and four times higher than in neighboring Ethiopia, EDD runs net operating losses, which have increased with the recent surge in oil prices. At the root of these problems is the dependence on imported oil, aggravated by large arrears from the public sector, an excessive, inadequately skilled and poorly motivated staff, and obsolete equipment. Cost recovery is also hampered by large technical and "non-technical" losses (illegal connections), respectively estimated at 10 and 6 percent of production. The ensuing precarious financial situation of the company has resulted in insufficient maintenance and investment, and inadequate service, with frequent power cuts at peak times.

There is little scope for substantial improvements over the short term. Some improvements can be achieved by enhancing financial transparency through the regular publication of audited accounts, enhancing efforts to reduce losses, and implementing a plan to increase savings in electricity consumption. The World Bank and other development partners are providing technical and financial assistance in these areas. According to the World Bank, some of the key areas of intervention in the short-term could be to:

- increase the efficiency of power generation by replacing older equipment;
- negotiate better fuel storage tariffs at the port or invest in own storage capacity;
- make operational the interconnection with the Ethiopian power grid (which would expand capacity and reduce costs by up to 30 percent); and
- reduce the EDD's personnel costs. Wages and benefits represented 14 percent of total operating costs in 2006. Some personnel cost items, such as overtime payments and subsidized energy tariffs, could be reduced by improving personnel management and renegotiating contracts.

In the medium to long term, Djibouti's competitiveness will depend on developing a reliable array of alternative energies. While fuel-based plants will continue to have a role as a flexible back-up, the main source of primary energy shall come from renewable resources, for which the country is well endowed. In order to achieve this objective, large investments are needed, structured along the lines of a comprehensive strategic plan, with assistance from Djibouti's development partners and with full involvement from the private sector. Exploration and development of geothermal resources to help address power shortages and reduce carbon emissions has started in 2008, in partnership with foreign investors (Reykjavik Energy Invest/Iceland and InfraVentures). This is the first project to be funded by InfraVentures, a new International Finance Corporation fund created to finance infrastructure development in low-income countries (LICs). The capacity of this geothermal plant is expected to be at least 50 megawatts (about 80 percent of the current EDD capacity). Also, other smaller projects in the wind and solar energy fields are at different stages of development.

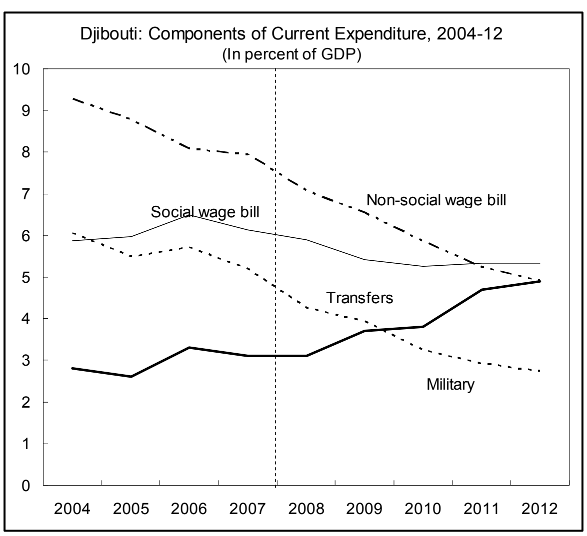
IV. THE ECONOMIC AND FINANCIAL PROGRAM

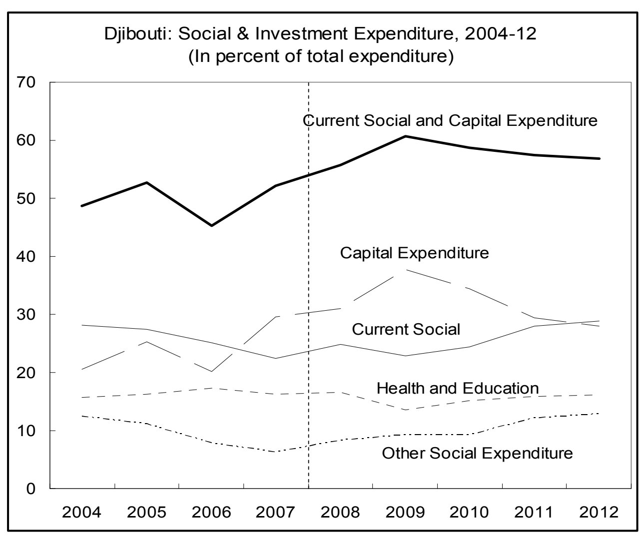
A. Program Objectives and Medium-Term Policy Framework

25. **Program objectives:** taking into account the issues discussed above, the program aims at fostering sustainable and balanced economic growth through macroeconomic stability, improved competitiveness, reduced inflation, and a strengthened external position. In the meantime, the program will liberate fiscal resources to support the implementation of the authorities' PRS. It intends to increase the growth rate to about 7 percent; keep the inflation rate close to 3–3.5 percent; sustain a currency board coverage ratio of at least 105 percent, and reduce the stock of domestic arrears from 18 percent of GDP at end-2007 to 7.5 percent at end-2011 (see ¶14 above).

26. **The program focuses** on: (a) bringing the overall fiscal position to a balance in the medium term while increasing the share of social and infrastructure projects in total spending; (b) strengthening financial sector soundness; (c) improving competitiveness mainly through a reduction in domestic production costs; and (d) building institutional capacity, particularly strengthening the statistical framework, fiscal transparency, and public sector governance. The specific policy measures envisaged under the program are consistent with the Article IV policy discussions, and are detailed in the Memorandum of Economic and Financial Policies (MEFP). The authorities will consider prompt implementation of FSAP's recommendations in areas considered urgent and frame their medium-term banking supervision and money management policies along the lines of the guidance provided.

27. **The authorities' fiscal policy under the program aims at balancing the budget in the medium term while increasing spending for poverty reduction** (MEFP ¶17). The overall deficit (on a commitment basis) would be brought to balance by 2011, while current expenditure on social programs would increase to about 11½ percent in 2011. A balanced budget is needed to create fiscal space for social expenditures without compromising





macroeconomic stability and is consistent with strengthening debt sustainability. Tax reforms and improvements in tax administration would reverse the decline in tax revenue and bring it back to about 20 percent of GDP by 2011. Additional measures would be adopted to contain current expenditure not related to the poverty reduction strategy, and the public investment program would be financed mainly by external grants and concessional loans. The wage bill would be further contained in the medium term by the reform of the civil service, including completion of organizational and strategic audits.

B. Key Measures Under the First Year of the Program (September 2008–August 2009)

28. **A VAT would be introduced in January 2009 with a single rate of 7 percent** (MEFP ¶19). The VAT law would be submitted to the National Assembly with the revised 2008 Budget, at the latest in November 2008. The VAT would be applied to all goods and services with few exceptions, which include banking and financial services and basic food items, thus widening the tax base and reducing exemptions. It is projected to increase revenue by about 1.1 percent of GDP in 2009 and 2.5 percent in the medium term. In order to ensure a smooth transition to the new regime, the staff encouraged the authorities to complete the implementation of all FAD's TA recommendations. The authorities also intend to phase out the TIC and TPS, introduce the TEC in 2010, revise the personal income tax regime, and make additional efforts to expand the tax base by streamlining exemptions by February 2009 (MEFP ¶20, Box 2 and ¶15 above).

29. **Current primary spending would be contained by improving expenditure management, reducing expenditure in low-priority areas, and gradually reducing the wage bill** (MEFP ¶22). Given the negative impact of relatively high labor costs on Djibouti's competitiveness, a freeze in public sector recruitment (except for the ministries of Health and Education and to strengthen the MoF's Tax Department) and in the salary structure[4] would be imposed throughout the program's duration. It is expected that the conclusion of the civil reform by the end of the program creates the basis for a competitive public sector without the need for wage ceilings. The budget preparation process would be strengthened in line with the FAD TA recommendations, through a revision of budget classification by 2009 and through the introduction of a medium-term fiscal framework that shall form the basis for the 2010 budget law (MEFP ¶21).

30. **All outstanding external arrears would be cleared and domestic arrears reduced** by 1.2 and 1.3 percent of GDP in 2008 and 2009, respectively (MEFP ¶18 and 24). To prevent the accumulation of new domestic and external arrears, the authorities intend to introduce a single treasury account, prepare monthly treasury plans based on more accurate projections of revenue and expenditure needs, and increase the balance of government deposits at banks (MEFP ¶21 and ¶14 above). Moreover, they intend to request technical

[4] Salary structure refers to nominal wages (excluding promotions) (MEFP ¶22).

assistance to improve current debt management practices, including avoiding the accumulation of arrears (MEFP ¶18).

31. **The fiscal discipline embedded in the program will help improve debt sustainability.** The program assumes that the authorities will be able to mobilize a substantial level of exceptional financing from multilateral and bilateral creditors, on highly concessional terms. For projection purposes, staff assumed that the precutoff debt to the Paris Club will be rescheduled under classic terms. Furthermore, in order to facilitate the mobilization of concessional external financing for the public investment program, a conference of external donors will be organized by November 2008 (MEFP ¶23, Box 2, and ¶3 above).

32. **The CBD would introduce reserve requirements on commercial bank deposits as a liquidity management instrument** (MEFP ¶29, and ¶18–19 above). Required reserves would support the authorities' multi-pronged effort to control inflation and mop up excess structural liquidity.[5] The specific characteristics of reserve requirements (level, computational base, remuneration) would be decided in consultation with local banks, and with TA from MCM. Moreover, the CBD would intensify banking supervision by increasing the number of on-site inspections, and commercial banks' capital requirements would be doubled (MEFP ¶31, Box 1, and ¶20 above).

33. **The program entails short-term measures to reduce the cost of domestic utilities and improve the business climate** (MEFP¶ 36–40). These include carrying out a study on the downsizing of the EDD that will trigger its downsizing, reducing the technical losses of the ONEAD, finalizing the interconnection agreement with Ethiopia, adopting the new commerce code, and enforcing the new labor code, including by adopting the implementation decrees and fostering the renegotiation of sectoral collective agreements (MEFP ¶37–41, Box 4, and ¶22–23 above).

34. **Short-term measures to improve the statistical framework include completing a full population census, followed by a comprehensive household expenditure survey, and a survey of economic activities.** This would help to update the various social indicators, including the provision of new estimates of poverty and income distribution, and improve the quality of national accounts' estimates (MEFP ¶42, and ¶24 above).

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[5] Should this measure become inconsistent with the forthcoming FSAP findings, it will be revised during the program's first review.

C. Program Modalities, Access Level, Monitoring, Risks, and Safeguards

35. **The staff concurs with the authorities' request for an access level under the requested PRGF of SDR 12.72 million (80 percent of quota).** The access level that would reflect Djibouti's status as a second-time PRGF user would be 65 percent of quota. However, given the impact of the food and oil price shocks on the projected financing needs of the country, the authorities request an augmented access level of 80 percent of quota, which is consistent with the level of access received by other countries facing similar shocks, the latest estimates of Djibouti's financing gap, and the projected capacity to repay the Fund (Table 7). To reinforce official reserves in 2008, 24 percent of quota would be frontloaded, while the rest of the facility would be disbursed in equal semi-annual tranches once reviews are completed (Table 6). The first review would assess performance of the criteria at end-2008. The program would be monitored by quantitative indicators on arrears, net credit to government, external borrowing and the currency board cover, and by structural performance criteria.

36. **Performance criteria and benchmarks fall within the Fund's areas of expertise and are critical to achieving the economic objectives and mitigating the program's risks**. The authorities see the introduction of the VAT in 2009 and improvements in liquidity management as essential to control inflation (MEFP's Table 1). The nine structural benchmarks cover reforms that are fundamental for maintaining macroeconomic stability and improving competitiveness (MEFP's Table 2). For example, reducing the cost of electricity is key for the development of the private sector (Box 4), and improvements in banking supervision and anti-money laundering are critical at this stage of development.

37. **The risks to the program are manageable.** Political and social tensions could hamper the implementation of the wide-ranging and thorny reforms, such as the freezing of recruitment in the public sector and of the nominal wage structure. Capacity constraints could limit the authorities' ability to implement reforms sufficiently rapidly to meet the needs of incoming FDI. Regional stability could also pose serious risks. Finally, further increases in oil and food prices could pose added strain on inflation and compromise fiscal sustainability. These risks are mitigated by the strong ownership of the program, which closely mirrors the development strategy elaborated by the authorities.

38. **The authorities have received an initial safeguard assessment (SA) mission.** The preliminary assessment indicated that although risks are present in a number of safeguard areas, these are partly mitigated by the relatively straightforward nature of the CBD's operations under the CBA. The full assessment is expected to be completed by the time of the first review under the PRGF arrangement. Based on the SA recommendations, a strategy would be developed to address any potential shortcomings in CBD's legal framework and financial controls, and specific remedial measures would be incorporated into future program reviews as needed.

V. Staff Appraisal

39. **Djibouti has a unique opportunity to achieve its development objectives.** The continued massive FDI inflows and the authorities' poverty reduction and investment strategies have the potential, if supported by adequate fiscal adjustment and structural reforms, to launch Djibouti on a broad-based, sustainable high-growth path and to achieve substantial progress in the pursuit of the MDGs.

40. **The authorities' poverty reduction strategy is a significant step in this direction**. The new PRSP presents a coherent set of measures for addressing the key structural problems that have hindered economic development. In order to achieve these objectives, however, it will be essential to strengthen macroeconomic stability by balancing the overall fiscal position while creating fiscal space to increase the share of social and infrastructure projects in total spending. The enhanced discipline introduced by the PRGF would further increase domestic and foreign investor's confidence.

41. **The staff welcomes the authorities' plan for a gradual fiscal adjustment based on a comprehensive tax reform, spending restraint, and better prioritization**. The introduction of the VAT has the potential to widen the tax base and partly reduce the current system of tax privileges to attract investment with a more stable, transparent, and, on average, lighter taxation. If adequately supported by improved audit controls and simplified compliance procedures, these reforms could substantially increase tax revenue in the medium term. However, timely implementation of the reforms is of the essence, particularly in view of the rapidly declining revenue path.

42. **The rapid expansion of the financial system is expected to lead to increased efficiency, but would require strengthening the oversight function of the CBD.** In particular, it is essential that the CBD reorganizes and reinforces substantially its banking supervision capacities, and that the legal and regulatory framework is updated to keep pace with the introduction of new financial institutions and instruments.

43. **In order to contain the mounting inflationary pressures, the authorities need to maintain their fiscal consolidation objectives and accelerate the implementation of structural reforms that increase productivity and competition.** Also, the introduction of reserve requirements by the CBD would help mop up structural liquidity. The authorities should refrain from introducing price controls or other restrictions that hamper the effective functioning of the market, which may result in the rationing of products and the emergence of black markets. The social concerns raised by the increasing food and oil prices would be better addressed by promptly developing a system of targeted subsidies to the poorest, with World Bank assistance.

44. **External financial assistance will be essential to address Djibouti's short and medium-term financing needs and to strengthen external sustainability**. The authorities should approach their bilateral and multilateral creditors to clear arrears, seek financial

assistance to cover their financing needs, and establish a sustainable path for the external debt.

45. **The staff agrees with the authorities that the CBA has contributed to maintaining macroeconomic stability.** However, while the slight overvaluation of the DF does not provide compelling evidence of misalignment, a variety of indicators suggest that competitiveness remains weak.

46. **The implementation of ambitious structural reforms remains critical to improve competitiveness and to foster economic growth.** In addition to fiscal and financial reforms, action is urgently needed to reduce costs and increase the efficiency of public enterprises (particularly the EDD); and to simplify regulations and procedures that affect the cost of doing business.

47. **Improving the statistical base is essential to guide and monitor macroeconomic and poverty reduction policies.** In this regard, staff urges the authorities to expedite the population census process followed by the household income and expenditure surveys, and to take full advantage of the TA offered by Djibouti's development partners.

48. **Staff recommends the approval of the authorities' request for a three-year PRGF arrangement** for SDR 12.72 million (80 percent of quota), with an upfront disbursement of 24 percent of quota.

49. It is proposed that the next Article IV consultation be held in accordance with the decision on consultation cycles approved July 15, 2002.

Table 1. Djibouti: Selected Economic and Financial Indicators, 2005–09

(Quota: SDR 15.9 million)
(Population: 0.82 million; 2006)
(Per-capita GDP: $946; 2006)
(Poverty rate: 42 percent; 2002)

			Est.	Projections	
	2005	2006	2007	2008	2009
National accounts					
Nominal GDP (in millions of Djibouti francs)	125,976	136,645	151,033	172,882	195,826
Nominal GDP per capita (in U.S. dollars)	894	946	1,020	1,139	1,259
Real GDP per capita	552	564	579	599	625
Real GDP per capita (annual percentage change)	1.4	2.3	2.7	3.4	4.3
Real GDP (annual change in percent)	3.2	4.8	5.3	5.9	6.9
Consumer prices (annual average)	3.1	3.6	5.0	8.1	6.0
Consumer prices (end of period)	3.5	3.5	8.2	7.5	5.5
	(In percent of GDP)				
Investment and saving					
Total fixed capital investment	23.2	35.0	42.1	43.7	41.9
Private	13.9	27.5	30.9	33.2	29.7
Public	9.3	7.5	11.2	10.4	12.3
Gross national saving	20.0	20.4	17.3	10.1	9.1
Savings/investment balance	-3.2	-14.7	-24.8	-33.5	-32.9
Budgetary operations					
Total revenue and grants	37.1	34.9	35.1	32.9	34.8
Of which: Tax revenue	20.0	20.3	20.5	18.4	18.6
Expenditure and net lending	36.8	37.4	37.7	34.9	36.6
Current expenditure	27.5	29.9	26.5	24.4	24.4
Capital expenditure	9.3	7.5	11.2	10.4	12.3
Balance (payment order basis)	0.2	-2.5	-2.6	-1.9	-1.8
Domestic financing	-0.3	-0.6	-0.2	-1.0	-1.0
External financing 1/	2.9	2.7	3.3	4.0	4.1
Change in domestic and external arrears (decrease -) 2/	-2.4	0.2	-0.7	-1.1	-1.3
	(Annual change in percent, unless otherwise indicated)				
Monetary sector					
Net foreign assets	12.0	15.3	4.0	3.7	3.7
Net domestic assets	8.7	-11.9	41.4	47.2	40.6
Claims on the private sector	1.2	9.1	23.1	34.8	28.6
Broad money	11.3	10.2	9.6	12.0	13.0
Velocity of broad money (ratio)	1.29	1.27	1.28	1.29	1.29
Commercial lending interest rate (in percent)	11.7	11.8	11.2	...	...
	(In millions of U.S. dollars, unless otherwise indicated)				
External sector					
Exports of goods and services 3/	288	312	363	420	503
Imports of goods and services	-391	-489	-641	-815	-938
Current account balance	-23	-113	-211	-326	-362
(in percent of GDP)	-3.2	-14.7	-24.8	-33.5	-32.9
FDI in percent of GDP	8.3	21.3	23.0	24.3	20.5
Stock of external public and publicly guaranteed debt 4/	440	435	504	573	655
(in percent of GDP)	62.0	56.6	59.3	58.9	59.5
Gross official reserves	88	117	130	132	143
(in months of imports of goods and services) 5/	2.2	2.2	1.9	1.7	1.8
Gross foreign assets of commercial banks	431	480	508	528	541
(in months of imports of goods and services) 5/	10.6	9.0	7.5	6.8	6.6
Memorandum items:					
Currency board cover (in percent) 6/	107.6	108.7	116.3	103.5	104.5
Exchange rate (DF/US$) end-of-period	177.7	177.7	177.7	…	…
Real effective exchange rate (annual average; 2000 = 100)	88.8	88.2	84.5	…	…
(End-year change in percent; depreciation -)	-1.1	-0.7	-4.2	…	…

Sources: Djibouti authorities; and Fund staff estimates and projections.

1/ Includes external arrears on amortizations.

2/ Domestic arrears include wage arrears and arrears to private and public suppliers for goods and services, to the pension fund, and to public enterprises. External arrears include arrears on interest only (arrears on principal are counted as an item of "external financing").

3/ Unlike the May 2007 staff report, cattle reexports for 2006 and 2007 are recorded on net basis.

4/ Includes external arrears and debt owed to Italy and Spain.

5/ In months of the following year's imports.

6/ Gross foreign assets of the CBD, in percent of monetary liabilities (reserve money and government deposits at CBD).

Table 2. Djibouti: Central Government Fiscal Operations, 2005–11

(In millions of Djibouti francs)

	2005	2006	2007	2008	2008	2009	2010	2011
			Est.	Budget	Projections			
Revenues and grants	46,714	47,742	53,002	54,618	56,964	68,100	72,312	80,874
Tax revenue 1/	25,133	27,690	30,901	30,543	31,769	36,452	41,764	49,432
Excl. overdue taxes	24,714	27,027	28,775	29,618	30,569	35,552	40,864	48,532
Direct taxes	11,573	13,066	14,831	13,949	15,309	16,074	16,764	20,613
Indirect and other taxes	13,560	14,624	16,070	16,594	16,460	20,378	24,999	28,819
Indirect taxes	12,289	13,250	14,288	14,849	14,665	18,359	22,768	26,349
Other taxes	1,271	1,374	1,782	1,745	1,795	2,019	2,231	2,471
Nontax receipts (domestic)	5,552	3,849	3,633	3,800	3,625	4,057	2,847	3,149
French and U.S. contributions	8,246	10,926	10,999	11,682	11,305	11,331	11,376	11,437
Grants	7,783	5,277	7,469	8,593	10,266	16,260	16,326	16,856
Investment	4,757	1,720	6,268	6,238	6,238	10,595	11,579	12,225
Current expenditure	3,026	1,926	1,201	2,355	2,355	3,665	2,647	2,631
Budget support	0	1,631	0	0	1,673	2,000	2,100	2,000
Total expenditure	46,410	51,118	56,885	56,840	60,287	71,714	75,952	81,092
Current expenditure	34,699	40,816	40,026	38,228	42,246	47,715	49,697	56,864
Wages and related expenditure	18,607	19,926	20,801	22,124	22,124	23,809	25,663	27,851
Wages and contributions	16,862	17,879	18,747	19,852	19,852	21,401	23,154	25,254
Housing subsidies 2/	1,745	2,047	2,054	2,272	2,272	2,408	2,509	2,597
Goods and services	7,653	12,359	10,542	7,484	11,110	11,687	11,703	14,058
Civil expenditure	5,439	9,264	7,400	6,019	8,388	9,345	9,981	12,276
Military expenditure	2,214	3,095	3,142	1,465	2,722	2,342	1,722	1,781
Maintenance	640	660	1,043	651	660	900	995	1,100
Transfers 3/	3,294	4,470	4,754	4,708	5,263	6,657	7,432	9,849
Interest	543	612	614	706	734	998	1,258	1,376
Foreign-financed current spending	3,961	2,789	2,272	2,555	2,355	3,665	2,647	2,631
Investment expenditure	11,711	10,302	16,859	18,612	18,041	23,998	26,256	24,228
Domestically-financed	3,504	4,528	5,360	5,927	5,156	5,000	5,800	6,750
Foreign-financed	8,207	5,774	11,499	12,685	12,885	18,998	20,456	17,478
Grants	4,757	1,720	6,268	6,238	6,238	10,595	11,579	12,225
Loans	3,450	4,054	5,231	6,447	6,647	8,403	8,877	5,253
Overall balance (commitment basis)	304	-3,376	-3,883	-2,222	-3,322	-3,613	-3,640	-218
Change in arrears (cash payments = -)	-3,054	219	-999	-2,200	-1,950	-2,500	-2,200	-2,200
Domestic arrears	-3,151	259	-958	-2,200	-1,950	-2,500	-2,200	-2,200
External arrears (interest)	97	-40	-41	0	0	0	0	0
Overall balance (cash basis)	-2,750	-3,157	-4,882	-4,422	-5,272	-6,113	-5,840	-2,418
Financing	2,750	3,157	4,882	4,423	5,273	6,114	5,840	2,418
Domestic financing (net)	-363	-840	-309	-1,236	-1,649	-1,913	-1,160	-701
Bank financing	-267	-744	-213	-1,140	-1,553	-1,817	-1,064	-605
Central bank	-78	-1,117	-531	-889	-1,302	-1,692	-1,064	-605
Commercial banks	-189	373	318	-251	-251	-125	0	0
Nonbank financing	-96	-96	-96	-96	-96	-96	-96	-96
External financing (net)	3,594	3,756	5,011	5,659	6,922	8,027	7,000	3,119
Disbursements	4,385	4,917	6,302	6,647	8,737	9,403	8,877	5,253
Amortization payments	-791	-1,161	-1,291	-988	-1,815	-1,376	-1,877	-2,134
Current obligations	-1,152	-1,181	-1,188	-988	-1,175	-1,376	-1,877	-2,134
Net change in arrears and rescheduling 4/	361	20	-103	0	-640	0	0	0
Residual/financing gap	-481	241	180	-1	0	0	0	0
Memorandum items:								
Current expenditure for social purposes	13,531	14,199	13,737	14,999	16,543	20,497	21,560	27,574
Expenditure on goods and services and domestically-financed investment	11,157	16,887	15,902	13,411	16,266	16,687	17,503	20,808
Base fiscal balance (excl. French and U.S. contributions) 5/	-2,457	-9,866	-7,361	-6,107	-8,346	-7,229	-6,917	-7,066
Base fiscal balance (incl. French and U.S. contributions) 5/	5,789	1,060	3,638	5,575	2,959	4,103	4,460	4,371
Domestic revenue	30,685	31,539	34,534	34,343	35,394	40,509	44,611	52,582
Domestically-financed expenditure	33,142	41,405	41,895	40,450	43,740	47,737	51,527	59,648
Revenue from the military bases	8,246	10,926	10,999	11,682	11,305	11,331	11,376	11,437

Sources: Djibouti authorities; and Fund staff estimates and projections.

1/ Excluding the French contribution.
2/ Previously included in transfers.
3/ Excluding housing subsidies.
4/ Assumes Paris Club rescheduling, clearance of non-eligible Paris Club debt, and similar treatment of other non-Paris Club bilateral debt.
5/ Defined as domestic revenue minus expenditure financed from domestic sources.

Table 2. Djibouti: Central Government Fiscal Operations, 2005–11 (concluded)

(In percent of GDP)

	2005	2006	2007	2008	2008	2009	2010	2011
			Est.	Budget	Projections			
Revenues and grants	37.1	34.9	35.1	33.1	32.9	34.8	33.0	33.1
Tax revenue 1/	20.0	20.3	20.5	18.5	18.4	18.6	19.1	20.2
Excl. overdue taxes	19.6	19.8	19.1	18.0	17.7	18.2	18.7	19.9
Direct taxes	9.2	9.6	9.8	8.5	8.9	8.2	7.7	8.4
Indirect and other taxes	10.8	10.7	10.6	10.1	9.5	10.4	11.4	11.8
Indirect taxes	9.8	9.7	9.5	9.0	8.5	9.4	10.4	10.8
Other taxes	1.0	1.0	1.2	1.1	1.0	1.0	1.0	1.0
Nontax receipts (domestic)	4.4	2.8	2.4	2.3	2.1	2.1	1.3	1.3
French and U.S. contributions	6.5	8.0	7.3	7.1	6.5	5.8	5.2	4.7
Grants	6.2	3.9	4.9	5.2	5.9	8.3	7.5	6.9
Total expenditure	36.8	37.4	37.7	34.5	34.9	36.6	34.7	33.2
Current expenditure	27.5	29.9	26.5	23.2	24.4	24.4	22.7	23.3
Wages and related expenditure	14.8	14.6	13.8	13.4	12.8	12.2	11.7	11.4
Wages and contributions	13.4	13.1	12.4	12.0	11.5	10.9	10.6	10.3
Housing subsidies 2/	1.4	1.5	1.4	1.4	1.3	1.2	1.1	1.1
Goods and services	6.1	9.0	7.0	4.5	6.4	6.0	5.3	5.8
Civil expenditure	4.3	6.8	4.9	3.6	4.9	4.8	4.6	5.0
Military expenditure	1.8	2.3	2.1	0.9	1.6	1.2	0.8	0.7
Maintenance	0.5	0.5	0.7	0.4	0.4	0.5	0.5	0.4
Transfers 3/	2.6	3.3	3.1	2.9	3.0	3.4	3.4	4.0
Interest	0.4	0.4	0.4	0.4	0.4	0.5	0.6	0.6
Foreign-financed current spending	3.1	2.0	1.5	1.5	1.4	1.9	1.2	1.1
Investment expenditure	9.3	7.5	11.2	11.3	10.4	12.3	12.0	9.9
Domestically-financed	2.8	3.3	3.5	3.6	3.0	2.6	2.6	2.8
Foreign-financed	6.5	4.2	7.6	7.7	7.5	9.7	9.3	7.1
Grants	3.8	1.3	4.2	3.8	3.6	5.4	5.3	5.0
Loans	2.7	3.0	3.5	3.9	3.8	4.3	4.1	2.1
Overall balance (commitment basis)	0.2	-2.5	-2.6	-1.3	-1.9	-1.8	-1.7	-0.1
Change in arrears (cash payments = -)	-2.4	0.2	-0.7	-1.3	-1.1	-1.3	-1.0	-0.9
Domestic arrears	-2.5	0.2	-0.6	-1.3	-1.1	-1.3	-1.0	-0.9
External arrears (interest)	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance (cash basis)	-2.2	-2.3	-3.2	-2.7	-3.0	-3.1	-2.7	-1.0
Financing	2.2	2.3	3.2	2.7	3.0	3.1	2.7	1.0
Domestic financing (net)	-0.3	-0.6	-0.2	-0.7	-1.0	-1.0	-0.5	-0.3
Bank financing	-0.2	-0.5	-0.1	-0.7	-0.9	-0.9	-0.5	-0.2
Central bank	-0.1	-0.8	-0.4	-0.5	-0.8	-0.9	-0.5	-0.2
Commercial banks	-0.2	0.3	0.2	-0.2	-0.1	-0.1	0.0	0.0
Nonbank financing	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0
External financing (net)	2.9	2.7	3.3	3.4	4.0	4.1	3.2	1.3
Disbursements	3.5	3.6	4.2	4.0	5.1	4.8	4.1	2.1
Amortization payments	-0.6	-0.8	-0.9	-0.6	-1.0	-0.7	-0.9	-0.9
Current obligations	-0.9	-0.9	-0.8	-0.6	-0.7	-0.7	-0.9	-0.9
Net change in arrears and rescheduling 4/	0.3	0.0	-0.1	0.0	-0.4	0.0	0.0	0.0
Residual/financing gap	-0.4	0.2	0.1	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
GDP	125,976	136,645	151,033	164,928	172,882	195,826	218,958	244,472
Current expenditure for social purposes	10.7	10.4	9.1	9.1	9.6	10.5	9.8	11.3
Base fiscal balance (excl. French and U.S. contributions) 5/	-2.0	-7.2	-4.9	-3.7	-4.8	-3.7	-3.2	-2.9
Base fiscal balance (incl. French and U.S. contributions) 5/	4.6	0.8	2.4	3.4	1.7	2.1	2.0	1.8
Domestic revenue	24.4	23.1	22.9	20.8	20.5	20.7	20.4	21.5
Domestically-financed expenditure	26.3	30.3	27.7	24.5	25.3	24.4	23.5	24.4
Revenue from the military bases	6.5	8.0	7.3	7.1	6.5	5.8	5.2	4.7

Sources: Djibouti authorities; and Fund staff estimates and projections.

1/ Excluding the French contribution.
2/ Previously included in transfers.
3/ Excluding housing subsidies.
4/ Assumes Paris Club rescheduling, clearance of non-eligible Paris Club debt, and similar treatment of other non-Paris Club bilateral debt.
5/ Defined as domestic revenue minus expenditure financed from domestic sources.

Table 3. Djibouti: Balance of Payments, 2005–13

(In millions of U.S. dollars, unless otherwise indicated)

			Est.	Projections					
	2005	2006	2007	2008	2009	2010	2011	2012	2013
Current account (including grants)	-23	-113	-211	-326	-362	-339	-318	-261	-233
(In percent of GDP)	-3.2	-14.7	-24.8	-33.5	-32.9	-27.5	-23.1	-17.1	-13.8
Credit	288	312	363	420	503	573	1,520	2,269	2,317
Exports of goods, f.o.b. 1/ 2/	40	55	79	98	113	127	1,028	1,742	1,756
Exports of services	248	257	284	323	391	446	491	527	562
Of which: services to foreign military bases	154	155	156	166	171	177	182	188	194
maritime transportation	43	48	73	85	126	147	160	168	182
Debit	-391	-489	-641	-815	-938	-981	-1,914	-2,598	-2,622
Imports of goods, f.o.b. 2/ 3/	-307	-392	-529	-667	-768	-802	-1,704	-2,387	-2,402
Of which: investment goods	-103	-234	-218	-261	-274	-283	-315	-275	-239
crude oil and petroleum products	-48	-59	-99	-121	-142	-151	-1,009	-1,694	-1,707
Imports of services	-84	-97	-111	-148	-170	-179	-209	-211	-219
Net income from abroad 4/	67	85	94	86	89	93	102	94	98
Of which: income related to the lease of military bases	46	61	62	64	64	64	64	65	65
Net current transfers from abroad	13	-21	-28	-17	-16	-24	-25	-26	-27
Private (net)	-15	-39	-38	-40	-41	-42	-44	-46	-48
Official (net)	28	18	11	22	25	19	19	20	21
Capital and financial account 5/	43	161	262	311	350	324	307	257	231
Net capital transfers	27	10	38	38	62	68	72	63	63
Foreign direct investment 6/	59	164	195	236	226	211	203	155	155
Public sector (net)	11	24	34	56	70	65	61	53	41
Disbursements	29	41	52	76	93	91	91	84	80
Repayments	-18	-17	-18	-20	-23	-26	-29	-30	-39
Of which: Eligible for Paris Club rescheduling	...	...	...	-32	-5	-4	-4	0	0
Commercial banks (- = increase in NFA)	-54	-36	-6	-20	-8	-20	-28	-15	-28
Errors and omissions	-26	-21	-43	0	0	0	0	0	0
Overall balance (deficit -)	-6	27	7	-16	-12	-15	-11	-5	-2
Financing	6	-27	-7	16	12	15	11	5	2
Central bank	5	-33	-16	-6	-17	-8	-11	-1	2
Assets	6	-30	-13	-1	-12	-3	-8	1	3
Liabilities	-1	-3	-3	-5	-5	-4	-3	-2	-1
Exceptional financing	0	6	8	22	29	23	22	6	0
Budget support from donors (grants and loans)	0	0	0	16	17	12	11	6	0
Change in overdue obligations (decrease-)	0	-5	8	-35	0	0	0	0	0
Expected debt relief	0	11	0	34	7	6	6	0	0
Paris Club	0	11	0	34	6	4	4	0	0
Stock (arrears)	0	0	0	29	0	0	0	0	0
Of which : debt service	0	0	0	6	6	4	4	0	0
Of which: principal	0	0	0	5	5	4	4	0	0
Of which: interest	0	0	0	0	0	0	0	0	0
Non-Paris Club	0	0	0	0	2	2	2	0	0
Stock (arrears)	0	0	0	0	0	0	0	0	0
Of which : debt service	0	0	0	0	2	2	2	0	0
Of which: principal	0	0	0	0	1	1	1	0	0
Of which: interest	0	0	0	0	0	0	0	0	0
Program financing	0	1	1	6	5	5	5	0	0
IMF (PRGF)	0	0	0	6	5	5	5	0	0
Memorandum items:									
Central bank gross foreign assets	88	117	130	132	143	146	155	154	151
In number of months of imports 7/	3.4	2.2	1.9	1.7	1.8	1.6	1.7	1.7	...
Currency board cover	107.6	108.7	116.3	103.5	104.5	102.2	100.4	101.3	99.4
FDI in percent of GDP	8.3	21	23	24	21	17	15	10	9
Official external debt (inc. public enterprises)									
In millions of U.S. dollars	440	435	504	573	655	727	796	847	888
In percent of GDP	62.0	57	59	59	59	59	58	56	53
In percent of exports of goods and services	152.7	139	139	136	130	127	52	37	38
Debt service									
In millions of U.S. dollars	25	26	28	28	33	39	41	48	57
In percent of GDP	3.5	3.3	3.3	2.8	3.0	3.1	3.0	3.1	3.4
In percent of exports of goods and services	8.7	8.2	7.8	6.6	6.6	6.7	2.7	2.1	2.5

Sources: Djibouti authorities; and Fund staff estimates and projections.
1/ Includes net exports of cattle since 2006.
2/ The large increase in exports and imports of goods in 2011onward reflects the coming online of the new refinery.
3/ The large increase in imports starting 2006 reflects FDI-related imports, mainly rising investment on the new port facility and free zone.
4/ Includes the French and U.S. contributions for the military bases and outflows of interest due on Paris and non-Paris Club debt.
5/ Excludes exceptional financing.
6/ Reflects FDI on oil terminal, the new port facility, the free zone, and other projects (particularly hotels).
7/ In months of the following year's imports. From 2010 onward, the ratio excludes crude oil imports destined for reexportation.

Table 4. Djibouti: Monetary Survey and Banking Sector Indicators, 2005–09

(End-of-period, in millions of Djibouti francs; unless otherwise indicated)

				Projections	
	2005	2006	2007	2008	2009
Broad money	97,709	107,718	118,032	133,960	152,386
Currency in circulation	13,272	15,445	15,500	17,478	18,466
Deposits	84,437	92,273	102,532	116,482	133,921
Demand deposits	34,456	40,924	52,041	59,121	67,956
Djibouti francs	23,746	26,371	33,080	37,581	43,196
Foreign currency	10,710	14,553	18,961	21,541	24,760
Time deposits	49,981	51,349	50,491	57,361	65,965
Djibouti francs	10,850	13,743	14,666	16,661	19,161
Foreign currency	39,131	37,606	35,825	40,699	46,804
Net foreign assets	79,604	91,766	95,468	98,979	102,657
Central bank	11,241	16,954	19,634	19,678	21,884
Assets	15,581	20,843	23,165	23,396	25,484
Liabilities	4,340	3,889	3,531	3,718	3,600
Commercial banks	68,363	74,812	75,834	79,301	80,773
Assets	76,533	85,301	90,276	93,887	96,234
Liabilities	8,170	10,489	14,442	14,586	15,462
Net domestic assets	18,105	15,952	22,564	34,981	49,730
Claims on government (net)	5,192	4,448	4,235	2,689	871
Central bank	4,366	3,249	2,718	1,423	-270
Commercial banks	826	1,199	1,517	1,266	1,141
Claims on nongovernment sector	26,346	28,523	35,683	47,497	60,589
Public enterprises	1,064	951	1,744	1,744	1,744
Private sector	25,282	27,572	33,939	45,753	58,845
Capital accounts	-8,471	-8,687	-9,412	-13,462	-13,462
Other items (net)	-4,962	-8,332	-7,942	-1,743	1,731
	(Change from previous year; in percent of broad money)				
Broad money	11.3	10.2	9.6	12.0	13.0
Currency in circulation	1.0	2.2	0.1	1.7	0.7
Demand deposits	-0.7	6.6	10.3	6.0	6.6
Time deposits	11.0	1.4	-0.8	5.8	6.4
Net foreign assets	9.7	12.4	3.4	3.0	2.7
Central bank	-1.2	5.8	2.5	0.0	1.6
Commercial banks	10.9	6.6	0.9	2.9	1.1
Net domestic assets	1.7	-2.2	6.1	10.5	11.0
Of which: Claims on government (net)	-0.3	-0.8	-0.2	-1.3	-1.4
Claims on nongovernment sector	0.3	2.2	6.6	10.0	9.8
Memorandum items:					
Monetary authorities:					
Net international reserves (in U.S. dollars million)	6	9	18	5	6
Gross foreign assets (GFA) (in U.S. dollars million)	88	117	130	132	158
GFA in percent of foreign currency deposits of banks	31	40	42	38	39
GFA in percent of total banking system deposits	18	23	23	20	21
Banking system:					
Credit to the private sector, 12-month percent change	1.2	9.1	23.1	34.8	28.6
Money velocity	1.29	1.27	1.28	1.29	1.29

Sources: Djibouti authorities; and Fund staff estimates and projections.

Table 5. Djibouti: Medium-Term Macroeconomic Projections, 2007–13

	Est.	Projections					
	2007	2008	2009	2010	2011	2012	2013
National accounts							
Nominal GDP (in millions of Djibouti francs)	151,033	172,882	195,826	218,958	244,472	271,129	299,411
Nominal GDP per capita (in U.S. dollars)	1,020	1,139	1,259	1,373	1,496	1,618	1,744
Real GDP per capita	579	599	625	654	699	734	768
Real GDP per capita (annual percentage change)	2.7	3.4	4.3	4.7	6.8	5.0	4.6
Real GDP (annual change in percent)	5.3	5.9	6.9	7.3	7.9	7.7	7.2
Consumer prices (end of period)	8.2	7.5	5.5	4.0	3.2	3.0	3.0
Consumer prices (annual average)	5.0	8.1	6.0	4.2	3.5	3.0	3.0
	(In percent of GDP)						
Consumption	82.7	89.9	90.9	89.0	85.0	83.6	81.0
Private	63.3	72.0	74.0	73.1	68.9	67.7	65.2
Public	19.4	17.9	16.9	15.9	16.1	15.9	15.7
Total fixed capital investment	42.1	43.7	41.9	38.5	38.1	33.5	32.9
Private	30.9	33.2	29.7	26.5	28.2	24.6	24.3
Public	11.2	10.4	12.3	12.0	9.9	8.9	8.5
Gross national saving	17.3	10.1	9.1	11.0	15.0	16.4	19.0
Savings/investment balance	-24.8	-33.5	-32.9	-27.5	-23.1	-17.1	-13.8
Budgetary operations							
Total revenue and grants	35.1	32.9	34.8	33.0	33.1	32.1	31.8
Of which: Tax revenue	20.5	18.4	18.6	19.1	20.2	21.2	22.2
Expenditure and net lending	37.7	34.9	36.6	34.7	33.2	32.4	32.1
Current expenditure	26.5	24.4	24.4	22.7	23.3	23.5	23.6
Capital expenditure	11.2	10.4	12.3	12.0	9.9	8.9	8.5
Balance (payment order basis)	-2.6	-1.9	-1.8	-1.7	-0.1	-0.2	-0.3
Domestic financing	-0.2	-1.0	-1.0	-0.5	-0.3	-0.1	0.1
External financing 1/	3.3	4.0	4.1	3.2	1.3	1.0	0.5
Change in domestic and external arrears (decrease -) 1/	-0.7	-1.1	-1.3	-1.0	-0.9	-0.7	-0.4
	(In millions of U.S. dollars, unless otherwise indicated)						
External sector							
Exports of goods and services 2/	363	420	503	573	1,520	2,269	2,317
Imports of goods and services 2/	-641	-815	-938	-981	-1,914	-2,598	-2,622
Current account balance	-211	-326	-362	-339	-318	-261	-233
(in percent of GDP)	-24.8	-33.5	-32.9	-27.5	-23.1	-17.1	-13.8
FDI in percent of GDP	23.0	24.3	20.5	17.1	14.7	10.2	9.2
External public debt in percent of GDP	59.3	58.9	59.5	59.0	57.9	55.5	52.7
Gross foreign assets of the central bank	130	132	143	146	155	154	151
(in months of imports of goods and services) 3/	1.9	1.7	1.8	1.6	1.7	1.7	...
Gross foreign assets of commercial banks	508	528	541	567	601	622	656
(in months of imports of goods and services) 3/	7.5	6.8	6.6	6.4	6.7	6.8	...

Sources: Djibouti authorities; and Fund staff estimates and projections.

1/ Domestic arrears include wage arrears and arrears to private and public suppliers for goods and services, to the pension fund, and to public enterprises. External arrears include arrears on interest only (arrears on principal are counted as an item of "external financing").
2/ From 2010 onwards includes crude oil imports destined for reexportation.
3/ In months of the following year's imports. From 2010 onwards the ratio excludes crude oil imports destined for reexportation.

Table 6. Djibouti: Reviews and Disbursements, PRGF Arrangement, 2008–11

Date	Action/Status	Disbursement	In Percent of Quota 1/
September 2008	Board approval of PRGF arrangement	SDR 3.864 million	24.00
March 2009	Completed first review based on end-December 2008 performance criteria	SDR 1.476 million	9.28
September 2009	Completed second review based on end-June 2009 performance criteria	SDR 1.476 million	9.28
March 2010	Completed third review based on end-December 2009 performance criteria	SDR 1.476 million	9.28
September 2010	Completed fourth review based on end-June 2010 performance criteria	SDR 1.476 million	9.28
March 2011	Completed fifth review based on end-December 2010 performance criteria	SDR 1.476 million	9.28
September 2011	Completed sixth review based on end-June 2011 performance criteria	SDR 1.476 million	9.28
Total		SDR 12.720 million	80.00

1/ Djibouti's quota is SDR 15.9 million.

Table 7. Djibouti Indicators of Capacity to Repay the Fund, 2006–17 1/

			Projections									
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Fund obligations based on existing credit												
(in millions of SDRs)												
Principal	1.09	1.82	2.73	2.73	2.18	1.64	0.91	…	…	…	…	…
Charges and interest	0.10	0.09	0.07	0.06	0.05	0.04	0.03	0.03	0.03	0.03	0.03	0.03
Fund obligations based on existing and prospective credit												
(in millions of SDRs)												
Principal	1.09	1.82	2.73	2.73	2.18	1.64	0.91	0.00	0.92	1.51	2.10	2.54
Charges and interest	0.10	0.09	0.08	0.09	0.09	0.10	0.10	0.09	0.09	0.09	0.08	0.06
Total obligations based on existing and prospective credit												
In millions of SDRs	1.19	1.91	2.81	2.82	2.27	1.74	1.01	0.09	1.01	1.60	2.18	2.60
In billions of Djibouti francs	0.31	0.52	0.81	0.82	0.66	0.51	0.30	0.03	0.30	0.48	0.65	0.78
In percent of government revenue	0.7	1.0	1.4	1.2	0.9	0.6	0.3	0.0	…	…	…	…
In percent of exports of goods and services	0.6	0.8	1.1	0.9	0.7	0.2	0.1	0.0	…	…	…	…
In percent of debt service 2/	6.8	10.4	16.4	13.9	9.7	7.0	3.5	0.3	…	…	…	…
In percent of GDP	0.2	0.3	0.5	0.4	0.3	0.2	0.1	0.0	…	…	…	…
In percent of quota	7.48	12.03	17.65	17.74	14.28	10.94	6.35	0.57	6.35	10.06	13.71	16.35
Outstanding Fund credit 2/												
In millions of SDRs	11.99	10.18	11.32	11.54	12.31	13.63	12.72	12.72	11.80	10.29	8.19	5.64
In billions of Djibouti francs	3.14	2.77	3.25	3.35	3.60	4.01	3.77	3.80	3.53	3.08	2.45	1.69
In percent of government revenue	6.6	5.2	5.7	4.9	5.0	5.0	4.3	4.0	...	...	...	...
In percent of exports of goods and services	5.7	4.3	4.4	3.7	3.5	1.5	0.9	0.9	...	...	...	...
In percent of debt service 2/	68.8	55.2	66.3	56.8	52.6	54.7	44.3	37.4	...	...	...	...
In percent of GDP	2.3	1.8	1.9	1.7	1.6	1.6	1.4	1.3	...	...	...	...
In percent of quota	75.44	64.01	71.19	72.58	77.42	85.72	80.00	80.00	74.21	64.72	51.51	35.47
Net use of Fund credit (millions of SDRs)	-1.09	-1.82	1.14	0.22	0.77	1.31	-0.91	0.00	-0.92	-1.51	-2.10	-2.54
Disbursements	0.00	0.00	3.86	2.95	2.95	2.95	0.00	0.00	0.00	0.00	0.00	0.00
Repayments and Repurchases	1.09	1.82	2.73	2.73	2.18	1.64	0.91	0.00	0.92	1.51	2.10	2.54
Memorandum items:												
Nominal GDP (in billions of DF)	137	151	173	196	219	244	271	299	...	...	...	...
Exports of goods and services (in billions of DF)	56	65	75	89	102	270	403	412	...	...	...	...
Government revenue and grants (in billions of DF)	48	53	57	68	72	81	87	95	...	...	...	...
Debt service (in billions of DF) 2/	5	5	5	6	7	7	9	10	...	...	...	...
DF/SDR (period average)	262	272	287	290	292	294	297	299	...	...	...	...

Sources: Fund staff estimates and projections.

1/ Assumes a new PRGF arrangement of SDR 12.72 million (80 percent of quota).
2/ Total debt service includes IMF repurchases and repayments.

Table 8. Djibouti: List of Main Current and Prospective Foreign Investment Projects, 2003–13

	Amount In millions of US$	Projected Completion Date
A. Financed by foreign direct investment		
Petroleum products		
Refinery financed by Kuwait	4000	2008–13
Of which: confirmed (45,000 b/d)	300	
Djibouti-Addis Ababa pipeline financed by Saudi Arabia	150	2008–13
Port		
Petroleum terminal	100	2003–05
Construction of petroleum terminal corridor	33	2005
Port's container terminal	370	2006–09
Transport		
Doraleh Road	15	2004
Doraleh-corridor road network to Ethiopia	20	2006–07
COMZAR: privatization of railway	50	2007–10
Finance and Telecoms		
Four new banks		2006–08
Sunmarine East African cable system (EASSY)	280	2007–13
Djibouti Telecom's international subsidiary		
Extension of mobile phone network	18	2009
Agriculture		
Cattle center	30	2007–08
Other sectors		
Free trade zone	35	2003–06
Mining projects (salt and precious stones)	15	2007–08
Housing (4,000 lodgings)	30	2007–13
Lake Assal geothermal project	160	2009–13
Other projects	100	2007–13
Total	5406	
excl. the non confirmed part of the refinery	**1706**	
for 2006–07	**359**	
for 2008–13	**1347**	
Of which: confirmed	**1186**	
B. Financed by foreign borrowing		
Infrastructure		
Electricity interconnection with Ethiopia's grid	50	2007–11
Boulaos market	25	2007–10
Other energy projects	48	2007–13
Roads	96	2007–13
Social sectors		
Education	42	2007–13
Health and sanitation	68	2007–13
Social housing	95	2007–13
Other		
Agriculture/cattle	5	
Rehabilitation	25	2007–08
Bulk terminal	40	2005–06
Lake Assal developments	28	2007–13
Development fund	10	2008–13
Other projects	120	2007–13
Total	**651**	

Source: Djibouti authorities as of March 2008.

Table 9. Djibouti: Status of the Structural Benchmarks of the July–December 2005 SMP	
Structural Reforms	Status
Publish the audited 2004 financial statements of public enterprises (Djibouti Télécom, EDD, ONED)	Completed. The audited financial statements for 2004 and 2005 were published on the website of the ministry of finance in December 2007. The authorities continued this practice by publishing the 2006 audited financial statements in 2008.
Finalize the unified registry of civil servants in 2005 and adopt it in 2006.	Completed. The single registry of civil servants has been installed online at the ministry of employment and civil service and at the ministry of finance.
Finalize the computerization of the expenditure chain.	Completed. New software (WMONEY) in use in the ministry of finance. Development of the conceptual scheme, as well as of all the specified functionalities, pilot testing, and the connection of other ministries to the network has been finalized.
Establish a new timetable for finalizing the code of commerce in 2006	Completed. A timetable for the adoption of the new code has been completed; a draft of the first volume (on commercial operations) was prepared in June 2007, and a revised version is expected to be completed by end-June 2008.
Adopt proposed measures for the VAT.	Partially completed. The introduction of the VAT has been announced in the 2008 Budget Law, and VAT provisions will be presented to the National Assembly with the 2008 Revised Budget Law or at the latest by November 2008. Implementation of the action plan for the introduction of the VAT will require additional external technical assistance.
Adhere strictly to the monthly cash flow plan.	Partially completed. The monthly cash flow plans have been irregularly prepared and adherence has been mixed.
Eliminate the practice of check exchanges with ONED and Djibouti Télécom.	Completed. Check exchanges continue only with the EDD as a way to facilitate payments.
Limit prepayment order expenditure to expenditure covered by legislation.	Completed, although there are transfers between budget categories.
Unify and simplify the system of tax exemptions by merging the various preferential tax regimes and including remaining exemptions in general tax code.	Partially completed. Coordination of the investment code and the general tax code completed. The texts on investment still need to be harmonized and the exemptions granted by special decree prior to introduction of the VAT need to be eliminated.
The government will report monetary and external debt data and the TOFE to the IMF each quarter, within a period of four weeks.	Completed as far as the monetary data are concerned. The TOFE is sometimes submitted with a lag of up to three months, and the debt figures are submitted with a long lag.

Table 10. Djibouti: Millennium Development Goals, 1990–2015

	1990	2000	2003	2006	2015 Goal
Goal 1: Eradicate extreme poverty and hunger					
Population below $2 a day (in percent)	...	...	42 1/	...	28 2/
Population below minimum level of dietary energy consumption (in percent)	...	...	...	...	
Poverty gap ratio at $1 a day (incidence x depth of poverty)	...	...	...	...	
Poverty headcount, national (percent of population)	...	...	...	...	
Prevalence of undernourishment (% of population)	53	...	...	24	
Prevalence of underweight in children (under five years of age)	23	...	...	...	
Goal 2: Achieve universal primary education					
Net primary enrollment ratio (percent of relevant age group)	31	32	...	...	
Primary completion rate, total (percent of relevant age group)	32	28	35	35	100
Proportion of pupils starting grade 1 who reach grade 5	87	88	...	...	
Youth literacy rate (percent of ages 15–24)	...	...	...	...	
School enrollment, primary (% net)	29	27		38	
Goal 3: Promote gender equality and empower women					
Proportion of seats held by women in national parliament (in percent)	...	...	11	11	
Ratio of girls to boys in primary and secondary education (in percent)	66	66	...	67	100
Ratio of young literate females to males (percent of ages 15–24)	78	90	91	...	
Share of women employed in the nonagricultural sector (in percent)	...	27	...	...	
Goal 4: Reduce child mortality					
Immunization, measles (percent of children ages 12–23 months)	85	50	...	67	
Infant mortality rate (per 1,000 live births)	116	97	...	86	
Under 5 mortality rate (per 1,000)	175	147	...	130	58
Goal 5: Improve maternal health					
Adolescent fertility rate (births per 1,000 women aged 15-19)	...	30	...	24	
Births attended by skilled health staff (percent of total)	...	...	61	...	
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	730	...	650	130
Goal 6: Combat HIV/AIDS, malaria, and other diseases					
Contraceptive prevalence rate (percent of women ages 15–49)	...	...	...	...	
Incidence of tuberculosis (per 100,000 people)	576	712	...	809	
Number of children orphaned by HIV/AIDS	...	4100	5000	...	
Prevalence of HIV, total (percent of population aged 15–49)	...	3	3	3	
Tuberculosis cases detected under DOTS (in percent)	...	61	53	40	
Goal 7: Ensure environmental sustainability					
Annual freshwater withdrawals, total (% of internal resources)	...	6	...	...	
Access to an improved water source (percent of population)	78	...	80	...	
Access to improved sanitation (percent of population)	48	...	50	...	
Access to secure tenure (percent of population)	...	...	...	...	
CO2 emissions (metric tons per capita)	1	1	...	1	
Forest area (percent of total land area)	0	0	...	0	
GDP per unit of energy use (2000 PPP $ per kg oil equivalent)	...	...	...		
Improved sanitation facilities (% of population with access)	79	81	...	82	
Improved water source (% of population with access)	72	73	...	73	
Marine protected areas, (% of surface area)	...	...	...	...	
Nationally protected areas (percent of total land area)	...	...	...	0	
Goal 8: Develop a global partnership for development					
Aid per capita (current U.S. dollars)	345	98	...	143	
Debt service (percent of exports excl. workers' remittances)	4	6	...	6	
Fixed line and mobile phone subscribers (per 1,000 people)	11	16	50	68	
Internet users (per 1,000 people)	...	2	...	13	
Personal computers (per 1,000 people)	2	10	22	...	
Unemployment, youth female (percent of female labor force ages 15–24)	...	...	...	...	
Unemployment, youth male (percent of male labor force ages 15–24)	...	...	...	...	
Unemployment, youth total (percent of total labor force ages 15–24)	...	...	...	...	
Other					
Fertility rate, total (births per woman)	6	...	5	4	
GNI per capita, Atlas method (current U.S. dollars)	850	760	...	1060	
GNI, Atlas method (current U.S. dollars) (billions)	...	1	1	1	
Gross capital formation (in percent of GDP)	14	9	...	30	
Life expectancy at birth, total (years)	51	53	...	54	
Literacy rate, adult total (percent of people ages 15 and above)	...	...	...	...	
Population, total (in millions)	1	1	1	1	
Trade (in percent of GDP)	132	85	...	97	

Sources: World Development Indicators database, April 2008; and Djibouti authorities.

1/ 2002.
2/ 2010 goal.

Table 11. Djibouti: Financial Soundness Indicators, 2000–07

(In percent unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006	Est. 2007
Capital adequacy								
Tier I capital to risk-weighted assets	17.3	18.5	21.7	19.1	15.0	15.7	17.4	8.1
Regular capital to risk-weighted assets	2.3	2.6	2.5	2.7	2.1	2.0	1.7	2.2
Reported total capital to risk weighted assets (K1-1)	114.2	99.5	96.5	104.5	101.5	106.2	102.7	91.0
Asset quality 1/								
Nonperforming loans to gross loans	19.7	26.9	30.6	29.2	28.8	27.8	24.5	17.8
Nonperforming loans net of provisions to capital	49.6	50.4	59.0	60.5	67.0	73.7	69.6	61.1
Provisions to nonperforming loans	54.7	55.5	52.3	52.5	55.1	56.6	57.4	56.5
Banks exceeding maximum single borrower limit 2/	1	0	0	2	1	0	1	1
Earning and profitability								
Reported return on assets (ROA) 3/	4.8	4.2	2.1	2.8	2.1	1.9	1.8	1.8
Reported return on equity (ROE) 3/	13.1	11.7	7.9	8.5	21.1	28.2	41.8	40.1
Interest margin to gross income	33.5	31.7	26.3	22.3	22.7	40.5	46.2	...
Noninterest expenditures to gross income	59.0	60.0	64.7	71.2	72.2	56.4	48.5	...
Salary expenditures to non-interest expenditures	60.9	62.9	61.8	60.7	54.0	59.1	56.7	...
Liquidity								
Liquid assets to total assets	47.5	58.5	64.9	70.5	74.3	76.6	75.4	72.1
Liquid assets to short-time liabilities	286	455	494	726	710	736	670	660
Liquid assets to demand and saving deposits	164	180	189	176	209	227	219	213
Liquid assets to total deposits	61.4	72.0	78.8	81.4	85.4	87.7	89.1	87.1
Sensitivity to market risk								
Net open position in foreign exchange to capital	77.4	79.1	66.8	63.3	80.1	101.5	84.9	72.9

Sources: Central Bank of Djibouti; and Fund staff estimates.

1/ Nonperforming loans include three loan classifications: watch, doubtful, and loss.
2/ Maximum single borrower limit is defined as 25 percent of capital (K3-1).
3/ From 2000–03, three banks reporting; from 2004–06 two banks reporting; from 2007 five banks reporting.

Table 12. Djibouti: Selected Income and Social Indicators

	Djibouti							Region 1/	
	1980–85	1990	2000	2003	2005	2006	2007	Low-Income Countries	Sub-Saharan Africa
Income									
Nominal GDP per capita (U.S. dollars)	1,036 2/	1,246	777	820	855	894	946	432 6/	740
Fertility rate, total (births per woman)	7	6	...	5	4	4	…	3	5
Immunization									
DPT (percent of children ages 12–23 months)	16	85	46	68	71	72	…	68	72
Measles (percent of children ages 12–23 months)	20	85	41	66	65	67	…	69	71
Life expectancy at birth									
Female (years)	47	49	...	43	56	56	…	62	52
Male (years)	43	46	...	43	53	53	…	59	50
Total (years)	45	48	...	43	54	54	…	60	50
Mortality									
Adult, female (per 1,000 female adults)	428	387	541	...	327	328	…	223	391
Adult, male (per 1,000 male adults)	527	472	590	...	366	363	…	285	421
Infant (per 1,000 live births)	137	119	102	97	88	86	…	74	94
Under-5 (per 1,000)	199	175	160	138	133	130	…	112	157
Population 3/	402,656 2/	557,992	714,574	764,838	794,962	818,508	…	2,419,656,270	781,821,747
Public spending on health, total (in percent of GDP)	...	...	3	3	6	…	…	...	...
Public spending on education, total (in percent of GDP)	...	...	9	9	8	8	…	...	...
School enrollment									
Primary (percent gross)	...	35 4/	33	38	42	44	… 5/	...	...
Secondary (percent gross)	...	12	18	...	23	22	…	...	...
Tertiary (percent gross)	...		1	...	2	2	…	...	...
Urban population (percent of total)	76	81	84	85	...			30	36

Sources: World Development Indicators (WDI); Djibouti authorities; and Fund staff estimates.

1/ Data correspond to 2006.
2/ 1985.
3/ WDI data, in line with recent updates by the United Nations Population Division.
4/ 1991
5/ 2004
6/ 2003

APPENDIX I. DJIBOUTI: JOINT BANK-FUND DEBT SUSTAINABILITY ANALYSIS (DSA)

The joint Bank-Fund low-income country debt sustainability analysis (LIC DSA) indicates that Djibouti's risk of debt distress continues to be high, despite some improvement in the medium-term projections. There are however important sources of vulnerability, including a worsening of financing conditions, lower than expected long-term growth rates, external shocks (such as further food and oil price increases), shortfalls in foreign direct investment, and contingent liabilities arising from government guarantees on external debt.

A. Background

50. **After improving considerably in 2006 following a debt restructuring agreement with Italy, Djibouti's debt situation remained broadly stable in 2007.** External debt (government and government-guaranteed) increased from 56.5 percent of GDP in 2006 to 59.5 percent of GDP in 2007, while government debt (external and domestic) declined from 63 percent to 62 percent of GDP.[6]

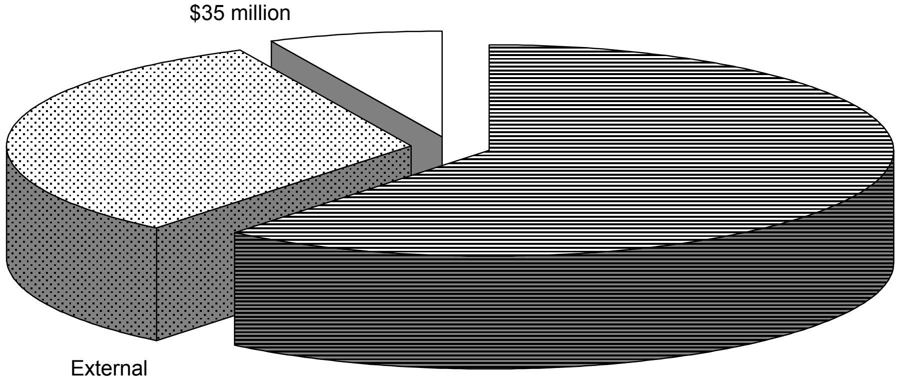
51. **Prospects for continued support from official creditors are good, and would be further enhanced under a Fund-supported program.** The country is receiving substantial financing from official multilateral and bilateral creditors to finance public investment in health, education, public housing, infrastructure, energy and water sectors, mostly in the form of earmarked project loans, including loans to state-owned enterprises under government guarantee. Major projects in the pipeline include the interconnection with the Ethiopian power grid (already under construction with financing from the African Development Bank and the European Union), a desalinization plant, the construction of new university buildings, and projects in energy, water, sanitation and social housing. Altogether, additional external lending for about $0.5 billion (equivalent to about 40 percent of average annual GDP) is projected to be disbursed between 2008 and 2013. About 40 percent of this financing had already been secured at end-2007, and the rest includes assistance pledged by Arab creditors during a Round Table held in Djibouti at end-2005. If agreement were reached on a Fund-supported program, all new lending agreements are expected to be extended on concessional terms, and additional financing could become available from the European Union, France, and other creditors in the form of budget-support loans and grants (estimated at about $40 million in 2008 and 2009). A donors' round table is scheduled for November 24–25, 2008 in Brussels, under World Bank coordination.

52. **Virtually all external debt—which amounted at end-2007 to $504 million, equivalent to 59 percent of GDP—is provided by official creditors either to the government or to state-owned enterprises under government guarantee (Appendix Table 13; Appendix Figure 3).** This includes $14 million of outstanding liabilities to the IMF, $150 million owed to the World Bank, $103 million to the African Development Bank, $57 million to the AFESD, and $51 million to bilateral Arab creditors

[6] The values for 2006 have been revised on the basis of a re-assessment of debt to Italy still outstanding after the 2006 rescheduling agreement.

(Appendix Table 14). Debt to multilateral creditors (with the notable exceptions of AFESD and OPEC countries) is on highly concessional terms, but debt to most bilateral creditors has a grant element below the 35 percent threshold considered concessional. About one-third of the debt ($163 million) is owed by state-owned enterprises under government guarantee.

Appendix Figure 3. Djibouti: Composition of External Debt, End-2007
(In millions of U.S. dollars)



Appendix Table 13. Amount and Composition of External and Government Debt, End-2007

	DF(In billions)	U.S. dollars (In millions)	Percent of GDP
External debt	**89.5**	**503.7**	**59.3**
External government debt (excluding arrears)	54.4	305.8	36.0
External government-guaranteed debt	29.0	163.3	19.2
Arrears on government and government-guaranteed debt	6.1	34.6	4.1
Government debt	**93.8**	**527.8**	**62.2**
External government debt	60.5	340.4	40.1
Direct external government debt	54.4	305.8	36.0
Arrears on government and government-guaranteed external debt	6.1	34.6	4.1
Domestic government debt	33.3	187.4	22.1
Gross government credit from banks	5.6	31.7	3.7
Government debt toward the port	0.6	3.4	0.4
Domestic arrears of the government	27.1	152.4	17.9

Appendix Table 14. Composition of Djibouti's External Debt (Excluding Arrears) at End-2007, by Creditor

Creditor	Outstanding Amount (In U.S. dollars)	Outstanding Amount (In Percent of Total External Debt)
World Bank (IDA)	149.8	31.9
African Development Bank	103.2	22.0
AFESD	57.1	12.2
Islamic Development Bank	15.7	3.3
IMF	14.4	3.1
OPEC	12.6	2.7
IFAD	2.7	0.6
Total multilateral creditors	**355.4**	**75.8**
Italy	21.3	4.5
Kuwait	25.2	5.4
China	21.3	4.5
Saudi Arabia	16.5	3.5
Abu Dhabi	9.8	2.1
Other bilateral creditors	19.6	4.2
Total external debt	**469.1**	**100.0**

53. **There are outstanding arrears toward external and domestic creditors but, except for arrears to Paris Club creditors, they mainly reflect weaknesses in liquidity management and do not stem from a lack of resources to service debt obligations.** Arrears on external debt service amounted at end-2007 to $35 million, equivalent to 4 percent of GDP and 7 percent of total external debt; these included about $29 million of arrears to Paris Club creditors on debt agreed before the cutoff date of March 31, 1998, which is potentially eligible for rescheduling and restructuring. Domestic arrears owed to state-owned enterprises, social security funds, public employees and government suppliers at end-2007 amounted to $152 million (18 percent of GDP) and accounted for about 30 percent of total government debt and for about 80 percent of domestic government domestic debt. Most external arrears outstanding at end-2006 (excluding those to Paris Club creditors) have been repaid, but new arrears—for a slightly lower amount—have been incurred in 2007; the authorities expect to clear all these arrears in by end-August 2008 (MEFP ¶18). In 2007 there has also been a large net repayment of domestic arrears, along the lines of a 10-year repayment plan that was adopted in 2002.

54. **Government debt amounted to $528 million, equivalent to 62 percent of GDP.** This included debt to external creditors, outstanding external and domestic arrears, and outstanding loans to banks and to the Port for $6.2 million that are gradually being repaid (Appendix Table 13).

55. **At present, public financing is only available from external official creditors.** Djibouti does not have access to international capital markets, and there is no market for domestic government debt. Under the currency board arrangement, the central bank is forbidden by law to lend to the government, and a domestic market for Treasury bills and bonds has not yet been established. Weaknesses in treasury management and cash planning have frequently resulted in the recourse to domestic and external payment arrears as a source of emergency short-term financing.

B. Underlying Assumptions

56. **The medium-term macroeconomic framework has improved compared with the previous two DSAs, reflecting increased investors' interest in Djibouti and the expectation that agreement on a Fund-supported program would result in the implementation of policy measures aimed at enhancing competitiveness and sustaining growth (Appendix Box 4).** These measures, which would include a major fiscal adjustment and structural reforms, would enhance growth prospects, promote economic diversification and increase export capacity and foreign direct investment. The 2005 DSA assumed wide-ranging reforms but comparatively low FDI, and more moderate growth rates in the medium term. The 2007 DSA (CR/07/178) took into account the larger FDI flows, but was based instead on economic assumptions that did not incorporate comprehensive fiscal and structural reforms.

57. **Past historical trends do not provide a good basis for future projections because Djibouti's economy is undergoing a deep and rapid transformation led by foreign and public investment.** Favored by its strategic position at the mouth of the Red Sea and among major shipping routes, and taking advantage of the increased regional integration that followed the re-routing of most Ethiopian external trade through the Djibouti Port since 1998, Djibouti has been expanding its port and transportation infrastructure with the support of massive foreign direct investment from the Gulf, with the aim of transforming the country into a thriving regional trade and financial hub. At the same time, the authorities have pursued a program of public investment in social capital and infrastructure, aimed at reducing poverty and improving opportunities and access to basic services, with the support of external bilateral and multilateral donors. These investments are expected to result in a substantial acceleration of growth, which already started in 2006, and could be further enhanced by policy measures aimed at improving competitiveness.

58. **Prompted by foreign investment and productivity improvements under a Fund-supported program, real GDP is projected to achieve high and sustained growth rates in the medium term.** Large FDI inflows are expected between 2008 and 2013 in association with the completion of the new port, the building of an oil refinery and the establishment of new enterprises in the free-trade zone. Investment will then decline to more normal levels but will remain sustained over the next decade, enhanced by economic expansion and by the consolidation of Djibouti as a regional trading center. After 2018, FDI is projected to decline in percent of GDP and annual real GDP growth to slow down to a more sustainable steady state level. Imports will initially reflect foreign direct investment—that will prompt the purchase of equipment and other goods and services from

external suppliers—and will further increase in 2011 (together with exports) with the opening of the refinery. In the long term, productivity improvements and the expansion of domestic production will improve the balance of goods and services. The real exchange rate is expected to remain broadly stable, as upward pressures arising from capital inflows would be compensated by the mobilization of a largely underemployed labor force and by productivity improvements in the public administration and other nontradable sectors. This stability would facilitate the persistence of the fixed exchange peg to the U.S. dollar under the currency board arrangement.

Appendix Box 4. Djibouti: Macroeconomic Assumptions

The macroeconomic assumptions have improved considerably compared with the previous two DSAs, reflecting expectations of an agreement on a Fund-supported program. Growth and FDI inflows are projected to remain substantial over the next decade, prompting a marked growth in exports.

Real GDP growth is projected to increase to 7 percent by 2009 and remain between 7–8 percent until 2018, to decline gradually thereafter to a more sustainable steady state rate of 3.5 percent. Persistent growth rates well above the historical average would stem from productivity improvements induced by structural reforms under a Fund-supported program as well as from the enhancement in physical and human capital resulting from the externally financed public investment program and from massive inflows of FDI (projected at an annual average of 16 percent of GDP until 2013 and 6 percent of GDP thereafter).

Average **inflation** is projected to peak at about 8 percent in 2008 and to stabilize at 3–3.5 percent by 2011. Fiscal restraint under a Fund-supported program and structural reforms aimed at increasing competitiveness in the local market, combined with the fixed dollar peg under the currency board arrangement, are expected to keep inflation in this small open economy close to the average world level.

The non-interest **current account deficit** is projected to widen to 3 percent of GDP in 2008 and 2009 and then decline to about 14 percent by 2013, reflecting the decline in FDI inflows after the completion of the new port and the refinery. The non-interest current account deficit is then projected to narrow more gradually to less than 6 percent by 2028. **Exports** are projected to increase threefold, from about 45 percent of GDP in 2008–10 to about 140 percent of GDP, with the opening of an oil refinery in 2011. This will also be reflected in an equivalent increase in **imports**. In the long term, as a result of economic diversification and the expansion of export-oriented and import-substitution activities, export growth is projected to outpace the growth of imports.

The **fiscal position** is projected to come into balance by 2011 as a result of fiscal adjustment under a Fund-supported program, and to remain balanced in the long term. The discipline enforced under the currency board arrangement, together with limited opportunities to borrow from domestic and external private sources, are projected to contain the overall deficit below 1 percent of GDP. Grant financing and the availability of concessional loans are projected to decline after 2013 as a result of the growth of the economy. It is assumed however that external loans to finance the public investment program will continue to be available from official creditors in the long term, albeit on less favorable terms.

Debt to **Paris Club creditors** that was originated before the cutoff date of March 31, 1998, is assumed to be rescheduled on classic non-concessional terms. The amounts eligible for rescheduling would include arrears outstanding at the start of the Fund-supported program as well as debt service payments coming due during the period of the program (September 2008–August 2011). According to the terms of reference agreed with the Paris Club in 2000, repayments would be made in ten equal semi-annual installments starting in 2013, and interest would be due at an appropriate market rate, that is here assumed at 5 percent. Similar treatment is also expected from non-Paris Club bilateral creditors.

59. **The substantial pick up in real GDP growth projected in the baseline scenario is a continuation of the trend seen in 2006 and 2007**, when growth started to accelerate driven by increases in FDI. Productive capacity would be expanded in the near future as several investment projects, including the new port and free zones (Emirati capital), are nearing completion, and other large projects, including a refinery financed by Kuwait, are also confirmed for the period 2008–13 (Table 8 in the staff report). These investments carried out in the context of strategic partnerships with large public and private foreign investors (such as U.A.E.'s Dubai Ports) are bringing about important structural changes in the economy. Dependence on imports will be substantially reduced with the desalinization plant and the refinery, and other investment projects (salt mining, cattle reexport facilities, port and logistics services, and new luxury hotels) will boost export capacity. Planned large public investments in infrastructure and social services will also help increase competitiveness in the long-term. These investments will be completed in the nearer term with initiatives to promote the development of a vibrant private sector with domestic SMEs dedicated to service the large foreign-owned projects. Supporting initiatives include the revised commerce and labor codes which will provide a stronger legal framework for doing business and investment, the reform of public utilities' enterprises, and prudent macroeconomic policies.

60. **This favorable growth scenario is expected to be underpinned by a prudent fiscal policy.** In the long term, external grants and revenue from external sources associated with the military bases are projected to decline in percent of GDP, but fiscal reforms and improvements in tax administration implemented under the Fund-supported program would enhance long-term revenue mobilization. A combination of wage restraint, a reorganization of the civil service, and improvements in expenditure management are expected to contain current expenditure. At the same, with financial support from external donors, the government would continue to implement a public investment program aimed at promoting social development and public infrastructure. It is also assumed that, in order to enhance its credibility and foster the confidence of domestic and foreign investors, the government would avoid the accumulation of new arrears. This will be facilitated by treasury reforms and improvements in cash management implemented under the program. All external arrears are projected to be repaid or rescheduled in 2008, and the repayment of domestic arrears is expected to continue broadly in line with the 10-year repayment schedule.

61. **The government is not expected to borrow from private sources in the foreseeable future.** Although negotiable government securities may be introduced for liquidity management purposes in the medium to long term, a full-fledged market for government debt is not expected to develop within the projection period. Economic expansion and policy credibility under a Fund-supported program could facilitate prospects for future access to international financial markets, but, in order to maintain macroeconomic stability and debt sustainability, the government is expected to continue to base its borrowing strategy on the mobilization of external financing from official creditors on favorable (if not fully concessional) terms. Economic growth is however expected to result in a lower availability of concessional financing, which will be reflected in a decline in the average grant element of new loans.

C. Evaluation of External Debt Sustainability

62. **Under baseline assumptions, most external debt and debt service ratios are above the sustainability threshold, indicating a high risk of debt distress (Appendix Table 15a; Appendix Figure 4).** These ratios tend to improve in the medium and long-term, under the baseline scenario. The net present value (NPV) of debt, which at end-2007 stood at 50 percent of GDP, is projected to reach the 30 percent level considered sustainable for a country like Djibouti in 2016, mainly as a result of GDP growth, and remain close to that level thereafter. The NPV of debt-to-exports ratio is projected to cross the 100 percent threshold in 2009, and to improve considerably as a result of the opening of the oil refinery in 2011; even excluding this effect, this ratio is projected to maintain a downward trend, reaching about 40 percent by 2028 (Appendix Table 15a). Other debt sustainability indicators are well below their respective thresholds and are projected to improve in the medium term. The debt service-to-exports ratio remains, through the whole projection period, comfortably below the 15 percent threshold considered sustainable, even when exports of refined products are excluded from the denominator.

63. **However, external sustainability remains vulnerable to a worsening of external borrowing conditions and other external shocks.** If new borrowing could only be secured at interest rates 2 percentage points higher than under the baseline (A2 in Appendix Table 15b), the NPV of debt would remain above 50 percent of GDP throughout the projection period, with an upward trend after 2020. In the event of a high investment and low growth scenario (HI/LG, A3 in Appendix Table 15b), with new FDI failing to generate additional growth, annual real GDP growth would return to a steady state rate of around 3 percent by 2013 and the NPV of debt would reach 50 percent toward the end of the projection period. Djibouti could also be vulnerable to other types of external shocks whose effects have not been quantified, most notably less favorable inflows of FDI, a slower than projected increase in exports, and adverse developments in terms of trade and cross exchange rates. Lower FDI or lower exports would result in slower growth, weakening the improvement in debt sustainability produced by the endogenous debt dynamics (in the case of FDI, this effects could be partly compensated by a reduction in imports that could improve the current account balance); an unfavorable evolution of the terms of trade, resulting, for instance, from a protracted increase in international food and energy prices or by a devaluation of the U.S. dollar vis-à-vis other currencies, unless fully compensated by improvements in competitiveness (more likely to occur in the case of a devaluation of the U.S. dollar) would widen the current account deficit, increasing external borrowing needs. A devaluation of the dollar would also increase the domestic currency value of debt denominated in currencies other than the dollar (and not pegged to the dollar), which amounted at end-2007 to 85.4 percent of the total (excluding arrears) (Appendix Table 16).

Appendix Table 15a. Djibouti: External Debt Sustainability Framework, Baseline Scenario, 2007–28 1/

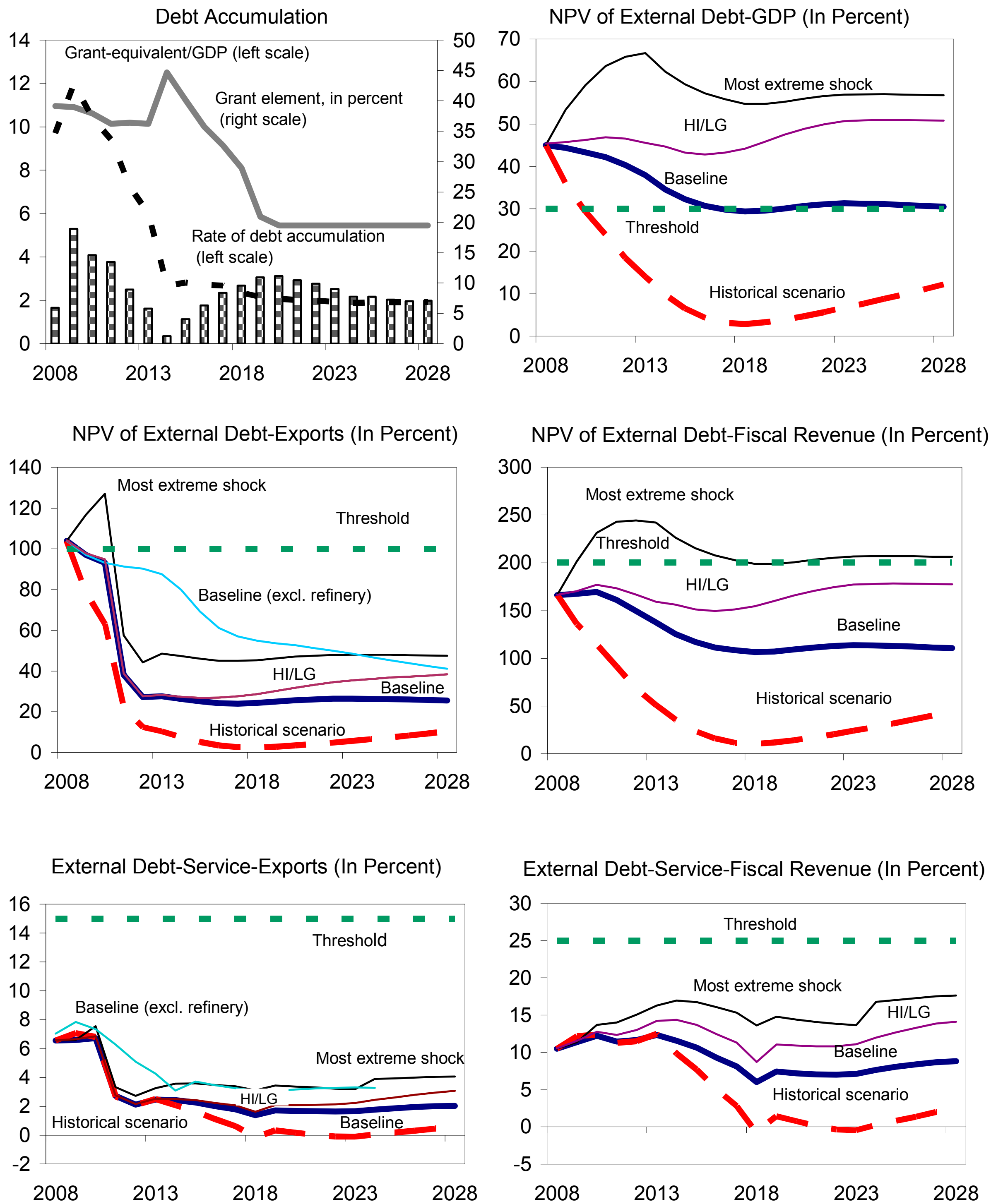
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 2/	Standard Deviation 2/	Projections										
	2005	2006	2007			2008	2009	2010	2011	2012	2013	2008-13 Average	2018	2023	2028	2014-28 Average
External debt (nominal) 1/	**62.0**	**56.6**	**59.3**			**59.4**	**60.6**	**60.4**	**59.5**	**57.1**	**54.1**		**41.8**	**40.4**	**37.3**	**41.5**
o/w public and publicly guaranteed (PPG)	62.0	56.6	59.3			59.4	60.6	60.4	59.5	57.1	54.1		41.8	40.4	37.3	41.5
Change in external debt	-5.8	-5.4	2.7			0.1	1.2	-0.2	-0.9	-2.5	-3.0		-1.3	-0.4	-0.5	-1.1
Identified net debt-creating flows	-9.2	-11.4	-3.6			6.2	8.8	6.4	4.1	2.9	0.9		0.5	1.0	0.7	0.8
Non-interest current account deficit	**2.4**	**13.9**	**24.0**	**5.7**	**8.5**	**32.7**	**31.8**	**26.4**	**22.1**	**16.1**	**12.8**		**9.5**	**6.4**	**6.0**	**8.1**
Deficit in balance of goods and services	14.5	23.0	32.6			40.6	39.4	33.1	28.6	21.6	18.1		12.1	8.4	7.5	10.5
Exports	40.6	40.6	42.8			43.2	45.7	46.5	110.5 3/	148.7	137.5		120.8	118.4	119.3	121.2
Imports	55.1	63.6	75.4			83.8	85.1	79.6	139.1 3/	170.3	155.6		132.9	126.9	126.9	131.7
Net current transfers (negative = inflow)	-1.8	2.7	3.2	-1.4	2.7	1.8	1.5	1.9	1.8	1.7	1.6		1.6	1.6	1.6	1.6
o/w official	-3.9	-2.4	-1.3			-2.3	-2.2	-1.5	-1.4	-1.3	-1.2		-1.2	-1.2	-1.2	-1.2
Other current account flows (negative = net inflow)	-10.2	-11.8	-11.8			-9.7	-9.1	-8.6	-8.4	-7.2	-6.9		-4.2	-3.6	-3.2	-4.1
Net FDI (negative = inflow)	**-8.3**	**-21.3**	**-23.0**	**-7.0**	**9.0**	**-24.3**	**-20.5**	**-17.1**	**-14.7**	**-10.2**	**-9.2**	-16.0	**-6.9**	**-4.8**	**-4.9**	**-6.0**
Endogenous debt dynamics 4/	**-3.3**	**-4.1**	**-4.6**			**-2.2**	**-2.6**	**-2.9**	**-3.2**	**-3.1**	**-2.7**		**-2.1**	**-0.6**	**-0.4**	**-1.2**
Contribution from nominal interest rate	0.8	0.8	0.8			0.9	1.0	1.1	1.0	1.0	1.0		0.7	0.8	0.9	0.8
Contribution from real GDP growth	-2.0	-2.8	-2.7			-3.0	-3.6	-4.0	-4.3	-4.1	-3.7		-2.7	-1.4	-1.3	-2.0
Contribution from price and exchange rate changes	-2.1	-2.1	-2.7			…	…	…	…	…	…		…	…	…	
Residual 5/	**3.4**	**6.0**	**6.3**			**-6.1**	**-7.6**	**-6.6**	**-5.0**	**-5.3**	**-3.9**		**-1.8**	**-1.4**	**-1.3**	**-1.9**
o/w exceptional financing	-0.1	-0.8	-1.0			-2.3	-2.6	-1.8	-1.6	-0.4	0.0		0.0	0.0	0.0	0.0
NPV of external debt 6/	57.3	52.8	49.8			44.9	44.3	43.3	42.2	40.3	37.9		29.4	31.3	30.5	30.9
In percent of exports	141.1	129.9	116.4			103.9	97.1	93.1	38.2	27.1	27.6		24.3	26.4	25.5	25.5
NPV of PPG external debt	**57.3**	**52.8**	**49.8**			**44.9**	**44.3**	**43.3**	**42.2**	**40.3**	**37.9**		**29.4**	**31.3**	**30.5**	**30.9**
In percent of exports	**141.1**	**129.9**	**116.4**			**103.9**	**97.1**	**93.1**	**38.2**	**27.1**	**27.6**		**24.3**	**26.4**	**25.5**	**25.5**
In percent of exports, excluding refined oil	141.1	129.9	116.4			103.9	97.1	93.1	91.4	90.3	87.6		54.8	48.5	41.1	53.2
In percent of government revenues	**185.5**	**169.8**	**165.1**			**166.3**	**167.5**	**169.4**	**161.0**	**149.7**	**137.8**		**106.6**	**113.7**	**110.7**	**112.3**
Debt service-to-exports ratio (in percent)	**8.1**	**7.4**	**6.7**			**6.6**	**6.6**	**6.7**	**2.7**	**2.1**	**2.5**		**1.4**	**1.7**	**2.0**	**1.9**
Excluding exports of refined oil products	8.1	7.4	6.7			6.6	6.6	6.7	6.5	7.0	7.8		3.1	3.0	3.3	3.9
PPG debt service-to-exports ratio (in percent)	**8.1**	**7.4**	**6.7**			**6.6**	**6.6**	**6.7**	**2.7**	**2.1**	**2.5**		**1.4**	**1.7**	**2.0**	**1.9**
PPG debt service-to-revenue ratio (in percent)	**10.7**	**9.6**	**9.5**			**10.5**	**11.4**	**12.2**	**11.5**	**11.7**	**12.3**		**6.0**	**7.1**	**8.8**	**8.2**
Total gross financing need (billions of U.S. dollars)	0.0	0.0	0.0			0.1	0.2	0.2	0.1	0.1	0.1		0.1	0.1	0.2	0.1
Non-interest current account deficit that stabilizes debt ratio	8.3	19.3	21.4			32.6	30.7	26.6	22.9	18.6	15.8		10.9	6.8	6.5	9.2
Key macroeconomic assumptions																
Real GDP growth (in percent)	3.2	4.8	5.3	3.1	1.4	5.9	6.9	7.3	7.9	7.7	7.2	7.1	7.0	3.7	3.6	5.0
GDP deflator in US dollar terms (change in percent)	3.1	3.5	5.0	2.6	1.2	8.1	6.0	4.2	3.5	3.0	3.0	4.6	3.5	3.5	3.5	3.5
Effective interest rate (percent) 7/	1.2	1.4	1.5	1.4	0.1	1.7	2.0	2.0	1.9	1.9	2.0	1.9	1.7	2.2	2.5	2.0
Growth of exports of G&S (US dollar terms, in percent)	14.8	8.5	16.4	6.7	7.8	15.7	19.7	13.8	165.3 3/	49.3	2.1	44.3	7.6	7.7	7.3	7.7
Growth of imports of G&S (US dollar terms, in percent)	15.7	25.2	31.1	10.6	13.5	27.3	15.0	4.6	95.1 3/	35.8	0.9	29.8	7.0	7.2	7.2	7.2
Grant element of new public sector borrowing (in percent)	…	…	…	…	…	39.1	39.0	37.9	36.2	36.4	36.3	37.5	28.9	19.5	19.5	25.2
Aid flows (in millions of US dollars) 8/	83.1	68.8	100.7			147.6	186.1	178.0	181.4	166.7	163.5		54.6	51.3	72.6	61.2
o/w Grants	43.8	29.7	42.0			57.8	91.5	91.9	94.8	79.8	72.6		34.6	51.3	72.6	45.5
o/w Concessional loans	28.5	40.8	51.9			87.4	99.0	91.1	90.9	83.7	80.1		18.0	0.0	0.0	7.1
Grant-equivalent financing (in percent of GDP) 9/	…	…	…			9.7	12.0	10.4	9.4	7.2	6.0		2.3	1.9	1.9	2.2
Grant-equivalent financing (in percent of external financing) 9/	…	…	…			62.3	67.6	68.3	67.9	67.5	66.6		46.2	40.2	40.3	43.7
Memorandum items:																
Nominal GDP (millions of US dollars)	708.8	768.9	849.8			972.8	1101.9	1232.0	1375.6	1525.6	1684.7		2806.4	4157.2	5886.8	**3691**
(NPVt-NPVt-1)/GDPt-1 (in percent)						1.6	**5.3**	4.1	3.8	2.5	1.6	3.2	2.7	2.5	2.0	2.2

Source: Staff simulations.

1/ Includes both public and private sector external debt.
2/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.
3/ The sharp change in imports and exports reflects the start of oil refining.
4/ Derived as [r - g - r(1+g)]/(1+g+r+gr) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and r = growth rate of GDP deflator in U.S. dollar terms.
5/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.
6/ Assumes that NPV of private sector debt is equivalent to its face value.
7/ Current-year interest payments divided by previous period debt stock.
8/ Defined as grants, concessional loans, and debt relief.
9/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the NPV of new debt).

Appendix Figure 4. Djibouti: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2008–28



Source: Staff projections and simulations.

Appendix Table 15b. Djibouti: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2007–28
(In percent)

	Projections							
	2008	2009	2010	2011	2012	2013	2018	2028
NPV of debt-to-GDP ratio								
Baseline	45	44	43	42	40	38	29	30
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2008-27 1/	45	36	29	24	18	14	3	12
A2. New public sector loans on less favorable terms in 2008-27 2/	45	53	59	64	66	67	55	57
A3. High FDI does not contribute to higher growth in 2008-27	45	46	46	47	47	46	44	51
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2008-09	45	47	48	47	45	42	33	34
B2. Export value growth at historical average minus one standard deviation in 2008-09 3/	45	50	59	57	54	51	37	33
B3. US dollar GDP deflator at historical average minus one standard deviation in 2008-09	45	46	47	45	43	41	32	33
B4. Net non-debt creating flows at historical average minus one standard deviation in 2008-09 4/	45	61	73	70	67	63	44	35
B5. Combination of B1-B4 using one-half standard deviation shocks	45	52	62	60	57	54	40	37
B6. One-time 30 percent nominal depreciation relative to the baseline in 2008 5/	45	62	60	59	56	53	41	43
NPV of debt-to-exports ratio								
Baseline	104	97	93	38	27	28	24	26
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2007-26 1/	104	79	63	22	12	10	2	10
A2. New public sector loans on less favorable terms in 2007-26 2/	104	117	127	58	44	48	45	48
A3. High FDI does not contribute to higher growth in 2008-27	104	98	95	39	28	28	29	38
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2008-09	104	97	93	38	27	28	24	26
B2. Export value growth at historical average minus one standard deviation in 2008-09 3/	104	134	177	72	51	52	43	38
B3. US dollar GDP deflator at historical average minus one standard deviation in 2008-09	104	97	93	38	27	28	24	26
B4. Net non-debt creating flows at historical average minus one standard deviation in 2008-09 4/	104	134	158	63	45	46	36	29
B5. Combination of B1-B4 using one-half standard deviation shocks	104	123	148	60	43	43	36	35
B6. One-time 30 percent nominal depreciation relative to the baseline in 2008 5/	104	97	93	38	27	28	24	26
NPV of debt-to-revenue ratio								
Baseline	166	167	169	161	150	138	107	111
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2007-26 1/	166	136	115	91	69	51	10	44
A2. New public sector loans on less favorable terms in 2007-26 2/	166	201	231	243	244	242	199	206
A3. High FDI does not contribute to higher growth in 2008-27	166	170	177	173	167	159	154	177
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2008-09	166	176	188	179	166	153	118	123
B2. Export value growth at historical average minus one standard deviation in 2008-09 3/	166	190	231	217	201	185	134	119
B3. US dollar GDP deflator at historical average minus one standard deviation in 2008-09	166	175	182	173	161	148	115	119
B4. Net non-debt creating flows at historical average minus one standard deviation in 2008-09 4/	166	232	287	268	247	228	158	127
B5. Combination of B1-B4 using one-half standard deviation shocks	166	197	242	228	212	195	144	135
B6. One-time 30 percent nominal depreciation relative to the baseline in 2008 5/	166	234	236	225	209	192	149	154
Debt service-to-exports ratio								
Baseline	7	7	7	3	2	2	1	2
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2008-27 1/	7	7	7	3	2	2	0	1
A2. New public sector loans on less favorable terms in 2008-27 2/	7	7	8	3	3	3	3	4
A3. High FDI does not contribute to higher growth in 2008-27	7	7	7	3	2	3	2	3
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2008-09	7	7	7	3	2	2	1	2
B2. Export value growth at historical average minus one standard deviation in 2008-09 3/	7	8	10	4	3	4	3	3
B3. US dollar GDP deflator at historical average minus one standard deviation in 2008-09	7	7	7	3	2	2	1	2
B4. Net non-debt creating flows at historical average minus one standard deviation in 2008-09 4/	7	7	8	4	3	3	2	3
B5. Combination of B1-B4 using one-half standard deviation shocks	7	8	9	4	3	3	2	3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2008 5/	7	7	7	3	2	2	1	2
Debt service-to-revenue ratio								
Baseline	11	11	12	11	12	12	6	9
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2008-27 1/	11	12	12	11	12	12	-1	2
A2. New public sector loans on less favorable terms in 2008-27 2/	11	11	14	14	15	16	14	18
A3. High FDI does not contribute to higher growth in 2008-27	11	12	13	12	13	14	9	14
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2008-09	11	12	14	13	13	14	7	10
B2. Export value growth at historical average minus one standard deviation in 2008-09 3/	11	11	13	13	13	14	9	10
B3. US dollar GDP deflator at historical average minus one standard deviation in 2008-09	11	12	13	12	13	13	6	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2008-09 4/	11	11	14	15	15	15	11	11
B5. Combination of B1-B4 using one-half standard deviation shocks	11	12	15	15	15	15	9	11
B6. One-time 30 percent nominal depreciation relative to the baseline in 2008 5/	11	16	17	16	16	17	8	12
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	24	24	24	24	24	24	24	24

Source: Staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implici an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Appendix Table 16. Djibouti: Composition by Currency of External Debt Outstanding at End-2007 (Excluding Arrears)

Currency	Amount of Debt in U.S. dollars (millions)	Percent of Total External Debt
SDR and SDR-related currency units	287.7	60.9
U.S. dollars and currencies pegged to the dollar	68.6	14.6
Euro	32.5	6.9
Other currencies	82.3	17.5
Total	**469.1**	**100.0**

D. Evaluation of Fiscal Sustainability

64. **Fiscal sustainability indicators are also projected to improve remarkably in the medium term (Appendix Table 17a; Appendix Figure 5).** While there are no defined thresholds for government debt, the NPV of government debt is projected to decline from 55 percent of GDP (and about 160 percent of fiscal revenue and grants) in 2007 to about 33 percent of GDP (and about 100 percent of fiscal revenue and grants) by 2011, as a result of the fiscal adjustment that would be implemented under a Fund-supported program, including a large repayment of arrears. These ratios are projected to improve further in the long term as sustained growth, improvements in revenue collection, and a more efficient expenditure execution contain the primary deficit well below the estimated debt-stabilizing value. These improvements would occur under the assumption of a gradual decline in external revenue from the French and U.S. military bases, and of sustained rates of public investment. The debt service-fiscal revenue ratio is projected to remain at a comparatively low level, at 3–5 percent, throughout the projection period.

65. **A temporary setback in growth in the short term could result in a much less favorable evolution of fiscal sustainability .** If real GDP growth in 2009 and 2010 turned out close to 1.6 percent, equivalent to its historical average less one standard deviation (B1 in Appendix Table 17b), without further adjustments in public expenditure, the primary deficit would widen to a long-term average of about 3 percent, which would result in a renewed accumulation of debt after the initial decline related to the repayment of arrears. The NPV of debt would eventually climb back to about 50 percent of GDP and 200 percent of revenue by 2028, while the debt service would increase to absorb about 20 percent of fiscal revenue by 2028, raising concerns about debt sustainability.

Appendix Table 17a. Djibouti: Public Sector Debt Sustainability Framework, Baseline Scenario, 2005–28

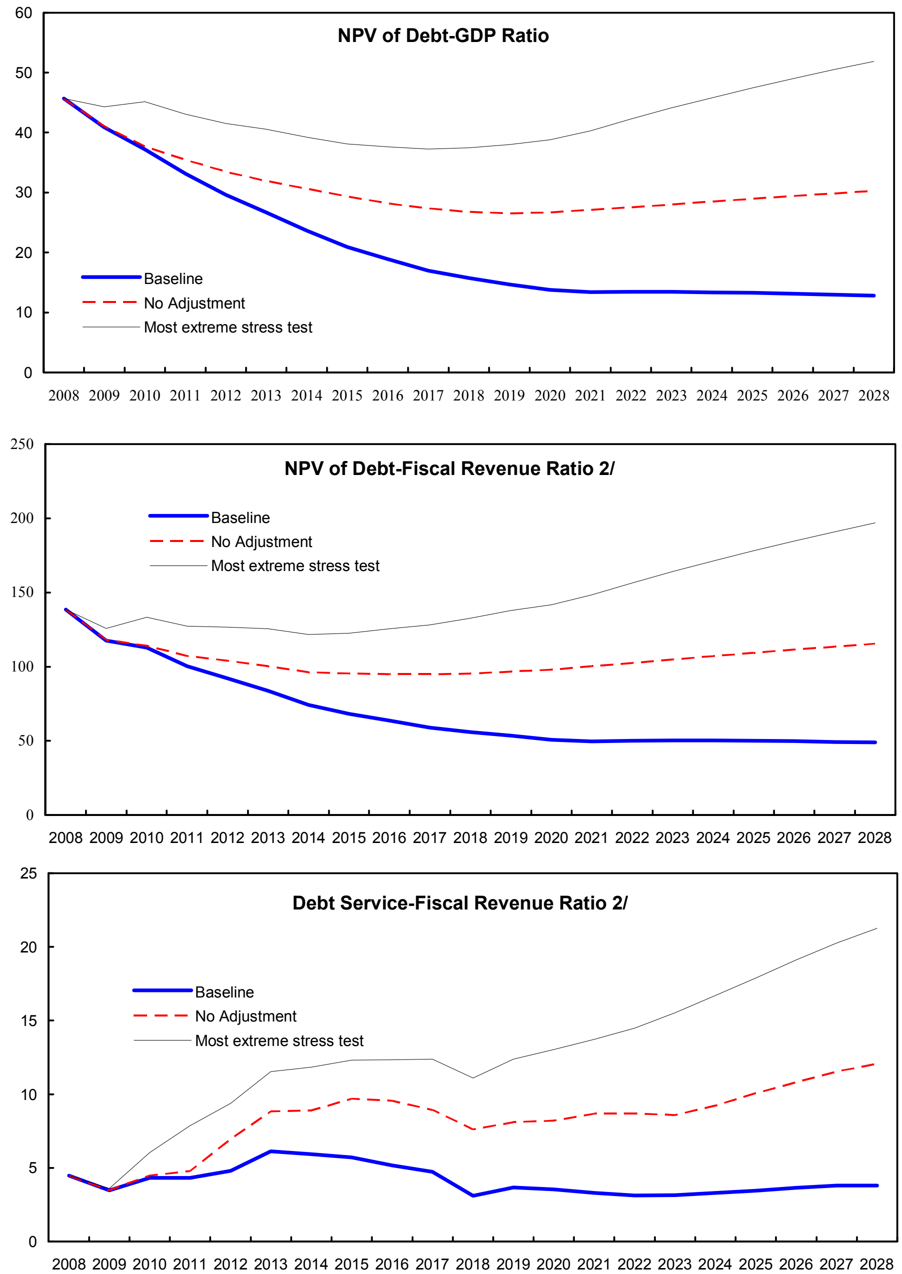
(In percent of GDP, unless otherwise indicated)

	Actual					Estimate	Projections									
	2005	2006	2007	Historical Average 5/	Standard Deviation 5/	2008	2009	2010	2011	2012	2013	2008-13 Average	2018	2023	2028	2014-28 Average
Public sector debt 1/	67.6	63.2	62.1			53.4	49.1	45.6	41.0	36.9	34.1	43.4	22.3	17.9	16.0	20.7
o/w foreign-currency denominated	40.3	38.0	40.1			35.9	35.6	34.9	32.5	30.2	28.4	32.9	20.9	17.7	15.9	19.5
Change in public sector debt	-6.1	-4.4	-1.1			-8.7	-4.3	-3.5	-4.6	-4.0	-2.8	-4.7	-1.8	-0.3	-0.3	-1.2
Identified debt-creating flows	-4.7	-1.6	-3.4			-5.9	-4.4	-3.5	-4.7	-3.8	-3.2	-4.3	-1.8	-0.3	-0.3	-1.2
Primary deficit	-0.7	2.0	2.2	1.6	1.1	1.5	1.3	1.1	-0.5	-0.3	-0.3	0.5	0.1	0.6	0.4	0.1
Revenue and grants	37.1	34.9	35.1			32.9	34.8	33.0	33.1	32.1	31.8	33.0	28.1	26.7	26.2	27.8
of which : grants	6.2	3.9	4.9			5.9	8.3	7.5	6.9	5.2	4.3	6.4	1.6	1.2	1.2	1.7
Primary (noninterest) expenditure	36.4	37.0	37.3			34.4	36.1	34.1	32.6	31.8	31.6	33.4	28.2	27.3	26.6	27.9
Automatic debt dynamics	-4.0	-4.8	-5.6			-7.4	-5.7	-4.6	-4.2	-3.5	-3.0	-4.7	-1.9	-0.9	-0.7	-1.3
Contribution from interest rate/growth differential	-4.0	-4.8	-5.6			-7.4	-5.7	-4.6	-4.2	-3.5	-3.0	-4.7	-1.9	-0.9	-0.7	-1.3
of which : contribution from average real interest rate	-1.7	-1.7	-2.4			-4.0	-2.3	-1.3	-0.9	-0.6	-0.5	-1.6	-0.3	-0.3	-0.2	-0.2
of which : contribution from real GDP growth	-2.3	-3.1	-3.2			-3.4	-3.4	-3.3	-3.3	-2.9	-2.5	-3.2	-1.6	-0.7	-0.6	-1.1
Contribution from real exchange rate depreciation	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0	...	...	...	
Other identified debt-creating flows	0.0	1.2	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	1.2	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes	-1.4	-2.8	2.4			-2.8	0.1	0.0	0.0	-0.2	0.4	-0.4	0.0	0.0	0.0	0.0
NPV of public sector debt	63.1	58.1	55.0			45.6	40.9	37.2	33.2	29.6	26.7	35.5	15.7	13.5	12.8	15.4
o/w foreign-currency denominated	35.8	33.0	32.9			28.2	27.4	26.5	24.8	22.9	21.0	25.1	14.3	13.2	12.6	14.2
o/w external	...	...	32.9			28.2	27.4	26.5	24.8	22.9	21.0	25.1	14.3	13.2	12.6	14.2
NPV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...	...	...	...	...	...
Gross financing need 2/	0.4	3.3	3.4			3.0	2.5	2.5	1.0	1.2	1.7	2.0	1.0	1.4	1.4	1.2
NPV of public sector debt-to-revenue and grants ratio (in percent)	...	...	156.7			138.5	117.6	112.6	100.3	92.1	83.7	107.5	56.0	50.3	48.9	54.9
NPV of public sector debt-to-revenue ratio (in percent)	...	...	182.4			169.0	154.5	145.5	126.7	110.0	96.8	133.8	59.4	52.8	51.3	58.6
o/w external 3/	...	...	109.3			104.4	103.4	103.7	94.5	85.1	76.3	94.6	54.0	51.8	50.6	54.2
Debt service-to-revenue and grants ratio (in percent) 4/	2.9	3.7	3.6			4.5	3.5	4.3	4.3	4.8	6.1	4.6	3.1	3.2	3.8	4.0
Debt service-to-revenue ratio (in percent) 4/	3.4	4.2	4.2			5.5	4.6	5.6	5.5	5.7	7.1	5.7	3.3	3.3	4.0	4.2
Primary deficit that stabilizes the debt-to-GDP ratio	5.4	6.4	3.2			10.2	5.6	4.6	4.2	3.7	2.6	5.1	1.9	0.9	0.7	1.3
Key macroeconomic and fiscal assumptions																
Real GDP growth (in percent)	3.2	4.8	5.3	3.1	1.4	5.9	6.9	7.3	7.9	7.7	7.2	7.1	7.0	3.7	3.6	5.0
Average nominal interest rate on forex debt (in percent)	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.1	2.0	2.0	2.4	2.6
Average real interest rate on domestic currency debt (in percent)	-1.7	-1.8	-3.2	-1.4	1.0	-5.6	-2.7	0.4	2.1	3.8	5.3		...	...	...	...
Real exchange rate depreciation (in percent, + indicates depreciation)	...	...	...	...	...	...	...	...	...	...	...		...	...	...	...
Inflation rate (GDP deflator, in percent)	3.1	3.5	5.0	2.6	1.2	8.1	6.0	4.2	3.5	3.0	3.0	4.6	3.5	3.5	3.5	3.5
Growth of real primary spending (deflated by GDP deflator, in percent)	1.1	6.4	6.1	4.5	7.1	-2.1	12.0	1.4	3.1	5.1	6.4	4.3	5.6	2.8	3.3	3.8
Grant element of new external borrowing (in percent)	...	...	...	...	...	0.0	0.0	0.0	0.0	0.0	0.0	0.0	28.2	19.5	19.5	24.5

Sources: Country authorities; and Fund staff estimates and projections.

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]
2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.
3/ Revenues excluding grants.
4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.
5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Appendix Figure 5. Djibouti: Indicators of Public Debt Under Alternative Scenarios, 2008–28 1/



Source: Staff projections and simulations.
1/ Most extreme stress test is test that yields highest ratio in 2018.
2/ Revenue including grants.

Appendix Table 17b. Djibouti: Sensitivity Analysis for Key Indicators of Public Debt, 2008–28

	Projections							
	2008	2009	2010	2011	2012	2013	2018	2028
NPV of Debt-GDP Ratio								
Baseline	46	41	37	33	30	27	16	13
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	46	43	41	40	39	39	37	41
A2. Primary balance is unchanged from 2008	46	41	38	35	33	32	27	30
A3. Permanently lower GDP growth 1/	46	41	38	34	31	28	19	26
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2009-2010	46	44	45	43	41	41	37	52
B2. Primary balance is at historical average minus one standard deviations in 2009-2010	46	42	40	36	32	29	17	14
B3. Combination of B1-B2 using one half standard deviation shocks	46	43	42	37	33	29	16	12
B4. One-time 30 percent real depreciation in 2009	46	51	46	41	36	32	19	16
B5. 10 percent of GDP increase in other debt-creating flows in 2009	46	50	46	41	37	34	21	16
NPV of Debt-Fiscal Revenue Ratio 2/								
Baseline	139	118	113	100	92	84	56	49
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	138	121	121	118	119	118	130	152
A2. Primary balance is unchanged from 2008	138	118	114	107	104	100	95	115
A3. Permanently lower GDP growth 1/	139	118	114	102	95	88	69	100
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2009-2010	139	126	133	127	127	125	133	197
B2. Primary balance is at historical average minus one standard deviations in 2009-2010	139	121	121	108	99	91	61	53
B3. Combination of B1-B2 using one half standard deviation shocks	139	124	125	110	101	91	57	46
B4. One-time 30 percent real depreciation in 2009	139	147	139	123	113	102	69	61
B5. 10 percent of GDP increase in other debt-creating flows in 2009	139	144	139	125	116	106	74	63
Debt Service-Fiscal Revenue Ratio 2/								
Baseline	4	3	4	4	5	6	3	4
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	4	4	5	5	8	10	10	16
A2. Primary balance is unchanged from 2008	4	3	4	5	7	9	8	12
A3. Permanently lower GDP growth 1/	4	3	4	5	5	7	5	10
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2009-2010	4	4	6	8	9	12	11	21
B2. Primary balance is at historical average minus one standard deviations in 2009-2010	4	3	6	6	6	7	3	5
B3. Combination of B1-B2 using one half standard deviation shocks	4	4	5	6	5	6	3	3
B4. One-time 30 percent real depreciation in 2009	4	4	4	4	5	6	4	5
B5. 10 percent of GDP increase in other debt-creating flows in 2009	4	3	14	8	7	8	4	6

Sources: Country authorities; and Fund staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).
2/ Revenues are defined inclusive of grants.

66. **Fiscal sustainability could also be adversely affected by other risks.** These include the materialization of contingent liabilities arising from government guarantees on the external debt of public enterprises, a failure to implement the projected fiscal adjustment, and a sharper-than-projected decline in fiscal revenue associated with the foreign military presence.

E. Conclusions

67. **Djibouti's debt sustainability outlook continues to exhibit a high risk of debt distress, although, if confirmed, the projected high sustained growth path would moderate this risk in the medium to long term.** The sustainability threshold for the NPV of external debt-GDP ratio is breached, in the baseline scenario, until 2017 (and occasionally thereafter), and the threshold for the NPV of external debt-exports ratio is breached until 2009 . All other debt indicators remain below the thresholds, and all indicators are projected to improve over time as a result of non-debt creating capital inflows and sustained GDP growth.

68. **Underpinning this outcome are the sustained interest of foreign investors in the country, the fiscal adjustment and structural reforms that are expected to be implemented under a Fund-supported program, and the availability of external concessional financing for an ambitious public investment program.** Together, these measures are expected to increase the competitiveness of the economy and place it on a sustainable long-term development path.

69. **Important vulnerabilities remain.** The sustainability assessment outlined above hinges on expectations of a prolonged period with stable, high growth rates. This outcome however is not assured. The precise impact of investment, fiscal stabilization and structural reforms on growth remains uncertain. Also, policy slippages and lower FDI could result in lower-than-expected growth rates. In view of these risks, high priority should be given to the prompt implementation of measures aimed at increasing external competitiveness, improving the business environment, and strengthening the fiscal position.

70. **The increase in economic and political instability in the region constitutes a major risk.** Djibouti's growth prospects are based on becoming a trade and financial hub to service the markets of Ethiopia and other neighboring East African countries. Whereas regional instability contributed in the past to expanding Djibouti's regional integration (by rerouting most of Ethiopia's external trade from Asmara to Djibouti), an intensification of instability and a worsening of the already precarious security situation in the region could threaten—or at least delay—the implementation of this project.

APPENDIX I. DJIBOUTI: RELATIONS WITH THE FUND
(As of July 31, 2008)

I. Membership Status: Joined: December 29, 1978; Article VIII

II. General Resources Account:	SDR Million	Percent of Quota
Quota	15.90	100.00
Fund holdings of currency	14.80	93.08
Reserve position in Fund	1.10	6.92

III. SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	1.18	100.00
Holdings	0.18	15.46

IV. Outstanding Purchases and Loans:	SDR Million	Percent of Quota
PRGF arrangements	8.54	53.72

V. Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
PRGF	10/18/99	01/17/03	19.08	13.63
Stand-by	04/15/96	03/31/99	8.25	7.27

VI. Projected Obligations to the Fund
(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2008	2009	2010	2011	2012
Principal	1.09	2.73	2.18	1.64	0.91
Charges/Interest	0.03	0.06	0.05	0.04	0.03
Total	1.12	2.79	2.23	1.68	0.94

VII. Implementation of HIPC Initiative: Not Applicable.

VIII. Implementation of MDRI assistance: Not Applicable.

Safeguards assessments

In 2001, during the safeguard policy transition period, BCD was subject to a review of the external audit mechanism, which recommended the appointment of an external auditor. Subsequently, the BCD hired in August 2002 external auditors from Ernst & Young (E &Y) to audit its 1999, 2000, and 2001 accounts. These audits were completed by end-2002.

Since 2003, the BCD has had its accounts audited on a yearly basis by E &Y, even though with a delayed timeframe. The BCD's yearly Balance Sheet and Income Statement are published in the Journal Officiel.

An initial safeguards assessment (SA) is underway in the context of the new PRGF arrangement. In this regard, a SA mission was conducted during June/July 2008. Staff met with the BCD authorities and their external auditors. The full assessment is expected to be completed by the time of the first review under the new PRGF arrangement. Based on the findings of this mission, a strategy will be developed to address any potential shortcomings in BCD's legal framework and financial controls, and specific remedial measures will be incorporated into the program as needed.

Exchange arrangements

Djibouti has a currency board arrangement. The Djibouti franc is pegged to the U.S. dollar at the rate of DF 177.721 = $1. Djibouti maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

Article IV Consultation

Djibouti is on an annual consultation cycle. Discussions for the 2007 Article IV consultation were held in Djibouti from January 7 to January 21, 2007. The staff report (IMF Country Report No. 07/178) was discussed by the Executive Board on May 27, 2007.

FSAP Participation, ROSC, and OFC Assessment

Djibouti has not participated in any of the above-mentioned exercises. An FSAP was requested by the authorities in 2007 and is planned for the last quarter of 2008. The FSSA will be available as part of the 2009 Article IV consultation documents. The onsite mission for the AML/CFT ROSC took place in October 2007, also in the context of the forthcoming FSAP. This AML/CFT component is expected to be concluded by the end of 2008 and is based on the 2004 Assessment Methodology. It will report on the observance of the FATF 40 recommendations for AML and the 9 special recommendations for CFT and Djibouti's level of compliance and recommendations on how the AML/CFT system should be strengthened.

Technical Assistance

FAD—Budget control and cash management of the treasury	April 2000
FAD—Direct tax reform	September 2000
FAD/MCD—Budget control and cash management of the treasury	February 2001
FAD—Tax administration and possible introduction of a VAT	April 2002
STA—Government finance statistics	May 2001
STA—National accounts and balance of payments statistics	January 2002
STA—Balance of payment statistics	November 2003
MFD—Banking supervision	December 2002
MFD—Banking supervision	December 2003
STA—Money and banking statistics	November/December 2004
FAD—Tax and customs administration	January/February 2005
MFD-Central banking accounting	October 2005
FAD—Tax administration	January 2007
FAD—Tax policy	January 2007
LEG—AML/CFT	June 2007
STA—Balance of payments statistics	June 2007
FAD—Tax policy	June 2007
FAD—Tax administration	July 2007
MCM—Central Bank Accounting	November 2007
STA—Monetary and Financial Statistics	December 2007
FAD—Public Fiscal Management	February 2008
MCM—Central Bank Accounting	February 2008

Resident Representative

A resident representative was stationed in Djibouti from October 1998 until April 2007.

APPENDIX II. WORLD BANK RELATIONS WITH DJIBOUTI
(As of end-June 2008)

World Bank lending and non-lending interventions in Djibouti are tailored to support the pillars of the CAS, which are broadly aligned with Djibouti's full PRSP endorsed by the Boards of the World Bank and the IMF in June 2004. The FY2005–08 CAS, endorsed by the Bank Board in March 2005, is centered on three pillars: (i) growth and competitiveness, (ii) human development, and (iii) governance.

The CAS pillars are supported by various **projects**. The current portfolio has six active Bank-funded projects valued at US$60.5 million. Of this total, 45 percent, by value, is for health-related activities, 17 percent for education, 12 percent for energy, 19 percent for urban infrastructure and flood emergency rehabilitation, and 8 percent for budget support in response to the food crisis. The distribution of projects across the CAS pillars is as follows:

- The growth and competitiveness pillar is being supported through: (i) a power sector project to lower the cost of the power utility and increase the poor's access to electricity; and (ii) a partial risk guarantee to the concession of the operation and management of the joint public railway company, following on a previous Bank road corridor project. Together with the port, transit activities along this corridor are a major source of growth in Djibouti.

- The human development pillar support focuses on: (i) a second school access and improvement project, following on a first successful project; (ii) two health sector projects (the HIV/AIDS, malaria and TB control and the health sector development projects); (iii) a social development and public works project; and (iv) an emergency floods rehabilitation project, for which an additional financing (grant) was approved on February 22, 2007.

- Support to the governance pillar is sought through IDF grants aimed at implementing the action plan and recommendations of the Country Financial Accountability Assessment (CFAA) and Country Procurement Assessment Review (CPAR).

In addition to the assistance through lending, the Bank supports Djibouti through **country analytical work**. Following a Public Expenditure Review completed in FY 2005, a country economic memorandum, aimed at recommending a set of policy options to face Djibouti's growth and competitiveness challenges, was completed in FY 2006. The Bank is also supporting the National Initiative for Social Development (INDS) by providing technical assistance to the INDS secretariat (SESN - *Secrétariat d'État chargé de la Solidarité Nationale*) in planning and monitoring policy reforms in close collaboration with the Fund. Close collaboration with the Fund is prevalent on macroeconomic issues (e.g., debt sustainability analysis) and on the PRSP evaluation and update. A joint FSAP is scheduled for FY 2009.

Finally, given Djibouti's weak institutional capacity, a great deal of emphasis is put on **technical assistance and capacity building efforts**. Currently, the Bank manages a portfolio of US$9.6 million in trust funds, including four IDF grants, two multiple donors' trust funds and a statistical capacity-building trust fund. The IDF grants finance institutional capacity building in the areas of public procurement (US$357,000), budget and debt management (US$343,000), and preparation of the implementation of an integrated social protection system (US$244,000). A fourth IDF grant was approved at the end of May 2008 to support the monitoring and evaluation systems of the INDS (US$284,000). The multiple donors' trust funds support Djibouti's participation to the Education for All Fast Track Initiative (US$6 million) and efforts aimed at controlling avian and human influenza (US$2.1 million). The statistical trust fund (US$252,700) supports the strengthening of national accounts and the implementation of a new census planned at the end of 2008.

In spite of Djibouti's poor economic environment, the overall performance of Bank projects is good and development objectives are expected to be achieved satisfactorily for all projects in the portfolio.

A new CAS covering the period FY09–FY11 is under preparation.

Appendix III. Djibouti: Statistical Issues

Outstanding statistical issues

Data provision has some shortcomings, but is broadly adequate for surveillance. Weaknesses are particularly significant in the areas of national accounts, the trade balance, and external debt, and to some extent for fiscal data. However, recent developments indicate an increasing awareness of the importance of statistics among government officials. In 2002, the authorities created the Directorate for Statistics and Demographic Studies (DISED) in order to enhance the capacity of the statistical system and the efficient use of available resources. Djibouti does not yet participate in the General Data Dissemination System (GDDS), but has submitted metadata and plans for improvements that are being reviewed.

National accounts

National account data have not been provided for publication in the *IFS* since 1999. With World Bank and UNDP assistance, the DISED has been re-estimating sectoral GDP for 2000–05 and elaborating national accounts according to the *1993 SNA* and updated statistical guidelines, using a wide range of data based on surveys, import statistics, and financial statements of public enterprises.

In 2009, once a population census has been completed, a survey to test its results using the polling basis in the poverty survey will be followed by a comprehensive household expenditure survey. This work will also help the revision of the CPI basket weights and to update various social indicators, in particular to provide new poverty and income distribution estimates (by end-2009). An economic survey, with support from development partners, to integrate the data in the estimated national accounts will also be carried out.

Prices

The Consumer Price Index (CPI), calculated by the DISED on a monthly basis since April 1999 using price surveys in Djibouti City, is the only measure of inflation. Before 1999, Fund staff monitored price developments on the basis of the CPI index compiled by the French government for French expatriate residents in Djibouti. The DISED is currently working to expand the national coverage of the index to areas outside the capital, as mentioned above.

Government finance

Following the establishment of a coordination unit in the Ministry of Finance (MOF) in 1998 to improve data coverage and timeliness, fiscal data are now available monthly although with some delays; however, these data do not cover a number of extra-budgetary accounts, including three pension funds. In 2002, a comprehensive audit of domestic arrears was completed with assistance from the European Union and the World Bank. Foreign-financed capital expenditure and some foreign-financed current expenditures and their financing (i.e., grants and loans) have been reported more regularly since 1999. However, additional efforts are needed to improve the compilation and coverage of fiscal data, particularly at the institutional level, in order to fulfill the recommendations made by a government finance statistics mission in 2001; the above-mentioned pension funds, also need to be incorporated into a consolidated general government budget. The MOF is reporting neither annual data for dissemination in the *GFS* Yearbook nor high-frequency data for publication in the *International Finance Statistics* (*IFS*).

Monetary accounts

Monetary statistics are generally adequate and cover the central bank and the aggregated balance sheet of all commercial banks. The authorities initiated the publication of a monthly bulletin in 2001. Monetary data are also posted on the BCD's web site (http://www.banque-centrale.dj/).

In 2004, a STA mission assisted the BCD in compiling monetary and financial statistics in accordance with the Fund's *Monetary and Financial Statistics Manual (MFSM)*. The mission highlighted various weaknesses, including the definition of the criterion of residence and the classification of domestic assets and liabilities by sector, and advised on the preparation of financial sector metadata for the General Data Dissemination System (GDDS). In September 2005, the BCD reported test monetary data to STA using the Standardized Report Forms (SRFs), which embody the methodology in the MFSM.

A follow-up monetary and financial statistics mission visited Djibouti during December 2–12, 2007. The mission: (1) reviewed progress made by the BCD in implementing the recommendations of the 2004 mission; (2) provided technical assistance in the major areas of data collection, compilation, and dissemination; (3) assisted and provided guidance for the migration to the SRFs for the reporting of monetary statistics to the IMF; (4) addressed BCD questions on implementing the methodology in the *MFSM*; (5) assessed institutional coverage and data sources for the collection of data for other financial corporations; and (6) reviewed GDDS metadata for the financial sector.

The mission found that the BCD has made little progress in implementing the recommendations of the 2004 mission mainly because of insufficient staffing. The mission addressed several issues highlighted by the MFS mission in 2004 as well as new issues that have arisen since then and agreed with the authorities on a work plan for further improving the monetary statistics. The BCD appointed a well-qualified division chief for monetary and banking statistics. This will enhance BCD's capacity to initiate the regular reporting of monetary data in the SRF format following the next MFS mission scheduled in December 2008.

External sector

Substantial progress has been made in improving balance of payments statistics in line with recommendations made by Fund's technical assistance missions over the past few years. Since August 2004, new balance of payments data adhering to the standards set forth in the *BPM5* are prepared. The new data set incorporates improvements involving transit trade to neighboring countries, imports by the foreign military forces stationed in Djibouti, and the treatment of the rent paid by the United States for the military base. The BCD is also compiling data on the country's international investment position (IIP) and has commenced collection of some balance of payments data on a quarterly basis.

However, significant issues remain, which were highlighted by a June 2007 mission. Three main problems were identified. The first one relates to trade statistics, which are no longer compiled by the DISED, essentially because of managerial changes within this entity. Therefore, the BCD has to make estimates of trade data, based on the trends in economic activity and direct investments in the country. The second problem is a lack of coverage of direct investment transactions in the BOP, which results mainly from the lack of human resources devoted to BOP work at the BCD. Finally, the estimates made to calculate workers remittances should be reviewed, as the figures appear underestimated (and which might help might explain most of the negative errors and omissions in the balance of payments). The mission also found that some improvements could be made to several items such as freight transportation, investment income, transactions related to the presence of foreign military bases in the country, the treatment of external debt statistics (through more comprehensive information provided by the *Direction du Financement Extérieur* (DFE)), and other investment of private sector (use of IBS data).

In 2007, the BCD resumed submission of balance of payments statistics for publication to STA. With financial and technical assistance from the World Bank and UNCTAD, the authorities adopted in 2002 a new system for the management of external debt, centralized within the DFE of the MOF; the system became operational in mid-2003, and external debt statistics were revised based on information received from creditors and covering the period from 1999 onward. Debt statistics continue to be provided irregularly and with delay.

Djibouti: Table of Common Indicators Required for Surveillance
As of August 19, 2008

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	Jul 2008	Aug 2008	M	M	NA
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	June 2008	July 2008	M	M	NA
Reserve/Base Money	June 2008	July 2008	M	M	M
Broad Money	June 2008	July 2008	M	M	M
Central Bank Balance Sheet	June 2008	July 2008	M	M	A
Consolidated Balance Sheet of the Banking System	June 2008	July 2008	M	M	A
Interest Rates[2]	Dec 2007	March 2008	M	M	A
Consumer Price Index	June 2008	July 2008	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	April 2008	June 2008	M	M	NA
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	April 2008	June 2008	M	M	NA
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Dec. 2007	June 2008	A	A	NA
External Current Account Balance	Dec. 2007	June 2008	A	A	A
Exports and Imports of Goods and Services	Dec. 2007	June 2008	Q	Q	A
GDP/GNP	Dec. 2007 [8]	June 2008	A	A	A
Gross External Debt	Dec. 2007	June 2008	A	A	I
International Investment Position[6]	2003	Jul 2007	A	A	A

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (excluding extra budgetary funds and social security funds, and state and local governments).
[5] Including currency and maturity composition. .
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D); Weekly (W); Monthly (M); Bi-monthly (B); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).
[8] GDP data estimated by staff on the basis of partial data provided by the authorities.

Translated from French

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

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[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)

	2007	Cumulative Flows from Beginning of the Year (unless otherwise indicated)				
		2008		2009		
		Sept. 31	Dec. 31	Mar. 31	Jun. 30	Sept. 31
	Dec. 31 Estimate	Indicative Targets	Performance Criteria	Indicative Targets	Performance Criteria	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
II. Ceiling on accumulation of new external arrears (MEFP ¶18, TMU ¶51) 3/ 2/	1,560 4/	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
VI. Floor on currency board cover (MEFP ¶12, ¶18, TMU ¶54) 7/ 2/	116	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.

Statement of the IMF Staff Representative on Djibouti
September 17, 2008

1. This statement updates information presented in the staff report and does not modify the thrust of the staff appraisal.

2. **While still at its peak, inflation growth has moderated and the drought and the steep increase in international food prices pose an immediate threat for a large share of the population.** Year-on-year inflation at the end of July remained at around 14 percent. Cereals (60 percent year-on-year price increase) and vegetables (44 percent) continue to be the main inflation drivers. The WFP estimates that about 150,000 people in Djibouti (about one-fifth of the population) are at risk of malnutrition. The drought is also causing the loss of livestock and displacing the rural population into urban areas. International aid agencies, including the WFP and USAID, have stepped up their emergency assistance programs; USAID is expected to provide over 1 million metric tons of food to the region during 2008 and a total of about US$3 million in emergency assistance to Djibouti. The WFP is also working to launch a voucher program to shelter the urban poor from the effects of food prices, and to provide food rations and assistance to farmers and livestock in rural areas. In addition, the UAE has provided a US$10 million grant for balance of payments support in July.

3. **Budget execution data up to May is broadly in line with projections.** Fiscal revenue appears broadly on target, prompted by a good performance of consumption taxes. There have been overruns on goods and services, although this could be partly due to the temporary misclassification of some investment expenditure. Expenditure on wages is also slightly above trend, and the intensification of the food crisis could pose additional expenditure requirements that would need to be compensated by cuts in low-priority areas.

4. **The authorities have confirmed that all external arrears vis-à-vis multilateral creditors have been cleared as of September 15, 2008.** Assurances were received from the Paris Club on the financing of the program, including on the clearance of bilateral arrears.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 09/81
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September 17, 2008

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2008 Article IV Consultation with Djibouti

On September 17, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Djibouti.[7]

Background

Djibouti's macroeconomic performance improved significantly, but inflationary pressures are intensifying. Real GDP growth accelerated to 5.3 percent in 2007, driven mainly by FDI concentrated in the construction and port services, while the contribution of public services to real GDP declined to 14.5 percent. The share of investment in GDP grew to about 42 percent. This rapid expansion, combined with the surge in food and oil import prices, pushed inflation from 3.5 percent in 2006 to 13.9 percent year-on-year in June 2008. In response, the authorities have eliminated consumption tax rates on five basic food items, and reached agreement with importers and retailers to cap their profit margins on these and other basic items.

The overall fiscal deficit remained at about 2.6 percent of GDP in 2007, even as the basic fiscal deficit (which excludes externally financed revenue and expenditure) narrowed from 7.2 percent in 2006 to 4.9 percent in 2007. Tax revenue declined by about 1 percent of GDP, as a result of tax exemptions granted to new investments and sluggish job creation. This decline was offset by an exceptional collection of overdue taxes. The decline in current expenditure from 30 percent of GDP in 2006 to about 26.5 percent in 2007, was more than compensated by a strong increase (3.7 percent of GDP) in public investment. Government external arrears at end-2006 have been repaid,

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[7] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

but new accumulations led to disbursement delays in some loans. External public and publicly guaranteed debt remained at about 60 percent of GDP.

After remaining stagnant for several years, credit to the private sector increased by 23 percent in 2007, owing in part to a real estate and construction boom and increased competition. The arrival of three new foreign banks in 2006–07, increasing the total to five, has fostered competition by reducing spreads and widening the range of financial instruments. Broad money growth slowed down to 9.6 percent due to a lower accumulation of banks' foreign assets. The capital adequacy ratio remained well above minimum requirements and asset quality improved. Greater confidence in the currency board and in the banking system led to a decrease in dollarization from 52.4 percent of total bank liabilities in 2006 to 51.4 percent in 2007, reducing financial vulnerability.

The deteriorating current account balance reflects mainly a surge in imports financed by foreign investment, but also the increase in food and oil prices. The external current account is estimated to have shifted into a deficit of about 25 percent of GDP in 2007—but this has been more than offset by the large capital and financial account surplus, resulting in a small increase in gross official reserves to US$130 million at end 2007 (equivalent to a currency board cover of 116 percent). The real effective exchange rate has depreciated by a cumulative of 24 percent in 2001–07, relative to its 2000 average, reflecting mainly the weakening of the U.S. dollar. Nevertheless, a variety of indicators, including high domestic production costs, suggest that competitiveness remains weak.

Significant progress has been achieved in the implementation of structural reforms. All key pending structural benchmarks of the 2005 Staff Monitored Program were implemented. In particular, progress was made in the areas of fiscal transparency, civil reform and the legal framework for private sector companies. The quality of monetary and balance of payment statistics is being strengthened with Fund technical assistance, and an assessment of the AML/CFT system was conducted by the Fund's legal department in 2007, in the context of a forthcoming FSAP.

The short-term outlook for growth is favorable, driven by a solid pipeline of large investment projects. Real GDP would increase by 5.9 percent in 2008. Inflation is expected to be slightly above 8 percent at end-2008, but would decline gradually thereafter as world food and oil prices ease. Revenue and expenditure measures are expected to reduce the overall fiscal deficit to 1.9 percent of GDP in 2008, while the current account deficit is projected to remain at about 33 percent of GDP, as FDI-related imports remain high.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. They welcomed Djibouti's strong economic growth driven by large foreign direct investments in the port and other key sectors of the economy. At the same time, Directors noted that the associated increase in inflation has been exacerbated by the surge in food and oil import prices, pointing to the need to contain inflationary pressures as a priority. Ensuring debt sustainability while reducing widespread unemployment and poverty remains a key challenge over the medium term. This will call for strict fiscal discipline

and the acceleration of structural reforms to broaden the economic base, enhance productivity, and promote private sector development.
Directors supported the authorities' economic program aimed at achieving macroeconomic stability, improving competitiveness, and strengthening the external position. They regarded the new Poverty Reduction Strategy (PRS) as a significant step toward addressing key structural bottlenecks. Directors underscored that a successful implementation of the Fund-supported program, which is critical for enhancing the confidence of investors and donors, will require strong program ownership and perseverance. They accordingly called on the authorities to take the necessary actions in this regard.

Directors emphasized the importance of maintaining the fiscal consolidation objective, with a view to controlling inflation and creating fiscal space to finance the poverty reduction strategy. Most Directors considered the fiscal adjustment path appropriate, noting the efforts already taken in, and planned for, 2008, especially those on the revenue front, which would only bear fruit in few years' time. A few Directors would have preferred a more front-loaded fiscal adjustment path than envisaged under the program, given the limited role of monetary policy under the currency board arrangement, the widening of the current account deficit, and the vulnerability of the budget to external financing conditions. Directors cautioned against reliance on price controls or other restrictions that may hamper the effective functioning of the market. They called for the prompt implementation of a system of targeted subsidies, with World Bank assistance, to alleviate the effects of high food prices on the poor.

Directors welcomed the medium-term objective of reaching a balanced fiscal position. They commended the authorities for the improvements already made in tax administration, and the plan for a comprehensive tax reform, including the introduction of a VAT and the streamlining of tax exemptions. Directors also welcomed the authorities' commitment to contain current expenditure by improving budget management, intensifying expenditure prioritization, and gradually reducing the wage bill. They called for continued efforts to reform the civil service and enhance fiscal transparency. Directors supported the authorities' request for Fund technical assistance to strengthen the budget management framework.

Directors stressed that Djibouti's still high risk of debt distress and vulnerability to a worsening of external borrowing conditions and other external shocks require the authorities' continued attention. They welcomed the clearance of arrears with multilateral creditors, and encouraged the authorities to negotiate a multilateral agreement with the Paris Club. The upcoming donors' conference provides a good opportunity to mobilize external financing needed for investment programs on highly concessional terms. Directors welcomed the authorities' intention to request technical assistance to improve debt management practices to help avoid the accumulation of new arrears.

Directors agreed that the currency board has served Djibouti well, contributing to enhanced confidence and macroeconomic stability. Directors noted the staff's assessment that the real effective exchange rate appears to be broadly in line with economic fundamentals, and encouraged the authorities to continue their efforts to improve external competitiveness, including by reducing the costs of critical production factors. In particular, Directors saw the need to downsize and improve the management of the two main loss-making public utility companies, and to develop alternative energy sources. They also encouraged the authorities to improve the business climate, including by adopting the new commerce code and enforcing the new labor code.

Directors welcomed the planned introduction of reserve requirements on bank deposits to mop up structural liquidity and help contain inflationary pressures. They stressed the need to reinforce the central bank's supervision capacities and to update the legal and regulatory framework to keep pace with the rapid expansion of the financial system. The forthcoming FSAP is expected to provide valuable guidance in this regard. Directors also looked forward to the implementation of the recommendations of the recent ROSC on AML/CFT issues.

Directors encouraged the authorities to take full advantage of the technical assistance offered by donors to improve the quality of statistics. They stressed, in particular, the importance of completing the population census and the household income and expenditure surveys to help monitor the effects of macroeconomic and poverty reduction policies.

The next Article IV consultation with Djibouti is expected to be held in accordance with the Executive Board decision on the consultation cycle for members with Fund arrangements.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Djibouti: Selected Economic and Financial Indicators, 2004–07

	2004	2005	2006	Prel. 2007
	(Annual change in percent)			
Production and prices				
Real GDP	3.0	3.2	4.8	5.3
CPI (average)	3.1	3.1	3.6	5.0
	(In percent of GDP)			
General government				
Total revenue and grants	35.6	37.1	34.9	35.1
Total expenditure	37.5	36.8	37.4	37.7
Balance (commitment basis)	-1.9	0.2	-2.5	-2.6
Balance (cash basis)	-3.0	-2.2	-2.3	-3.2
	(Annual change in percent)			
Monetary indicators				
Net foreign assets	18.6	12.0	15.3	4.0
Net domestic assets	-2.7	8.7	-11.9	41.4
Broad money	13.9	11.3	10.2	9.6
External sector				
Current account balance (in percent of GDP)	-1.3	-3.2	-14.7	-24.8
Gross official reserves (in months of imports) 1/	3.3	2.2	2.2	1.9

Source: Djibouti authorities.

1/ In months of the following year's imports.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

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FOR IMMEDIATE RELEASE
September 18, 2008

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves US$20 Million PRGF Arrangement for Djibouti

The Executive Board of the International Monetary Fund (IMF) has approved a three-year, SDR 12.72 million (about US$20 million) arrangement under the Poverty Reduction and Growth Facility (PRGF) for Djibouti in support of the government's economic program and its poverty reduction strategy.

The decision allows for an immediate disbursement to Djibouti of an amount equivalent to SDR 3.864 million (about US$6 million) that will contribute to strengthening Djibouti's external position against the effects of the food and oil price shocks.

Following the Executive Board discussion, Mr. Murilo Portugal, Deputy Managing Director and Acting Chairman, said:

"Djibouti's growth performance and prospects have improved significantly, driven by large foreign direct investments in the port and other key sectors of the economy. At the same time, this rapid expansion, combined with the surge in food and oil import prices, has pushed up domestic prices. The challenge remains to reduce widespread unemployment and poverty by expanding growth beyond an enclave around the port, while ensuring fiscal and debt sustainability. The authorities' program of economic and financial policies, supported by the Fund, aims to foster sustained, broad-based economic growth through macroeconomic stability, improved competitiveness, and a strengthened external position. The Fund's financial assistance under the PRGF arrangement with an augmented access will help Djibouti cope with the impact of the food and oil price shocks.

"The authorities have acted quickly to contain the hardship on the poor through temporary measures. These measures will be replaced by a system of targeted subsidies to be implemented with World Bank assistance. Competition-enhancing measures will also be stepped up to improve efficiency and reduce profit margins.

"The authorities are committed to bringing the overall fiscal position to a balance in the medium term by containing current expenditure (excluding social expenditures) and broadening the tax base. Improving competitiveness will require a concerted effort to reduce domestic production costs, through a decisive restructuring of loss-making state-owned enterprises and a permanent solution to the shortage and high price of electricity power. The planned adoption of a new commerce code and the implementation of the new labor code will also help improve the business climate.

“In the context of the currency board arrangement, taming inflation will depend heavily on fiscal discipline, complemented by the introduction of new monetary instruments to mop up structural liquidity and improved oversight of the expanding banking system. External financial assistance from the Fund and other donors will help fill the medium term financing gap of the program and contribute to financial stability. Debt management should be strengthened to ensure that Djibouti’s risk of debt distress follows a downward trajectory towards sustainability, while limiting new financing to grants and external borrowing on highly concessional terms.

“Djibouti’s National Initiative for Social Development is a significant step to address key structural bottlenecks. The expected completion of the new population census and household expenditure survey will be key to monitoring the effects of macroeconomic and poverty reduction policies going forward,” Mr. Portugal said.

The PRGF is the IMF's concessional facility for low-income countries. PRGF loans carry an annual interest rate of 0.5 percent and are repayable over 10 years with a 5½-year grace period on principal payments.

ANNEX

Recent Economic Developments

Djibouti's macroeconomic performance has improved significantly, but inflationary pressure is intensifying. Real GDP growth accelerated from 4.8 percent in 2006 to 5.3 percent in 2007, largely driven by foreign direct investments. The share of investment in GDP grew from 23 percent in 2005 to about 42 percent in 2007. This rapid expansion, combined with the surge in food and oil import prices, pushed inflation from 3.5 percent in 2006 to 13.9 percent year-on-year in June 2008. In response, the authorities have eliminated consumption tax rates on five basic food items, and reached agreement with importers and retailers to cap their profit margins on these and other basic items.

The overall fiscal deficit remained at about 2.5 percent of GDP in 2007, even as the basic fiscal deficit (which excludes externally-financed revenue and expenditure) narrowed from 7.2 percent in 2006 to 4.9 percent in 2007. The slight rise in the overall deficit in 2007 is explained by the large increase (3.7 percent of GDP) in public investment. External public and publicly-guaranteed debt remained at about 60 percent of GDP.

The external current account is estimated to have shifted from a small surplus in 2003 to a deficit of about 25 percent of GDP in 2007, but this has been more than offset by the large capital and financial account surplus, resulting in a small increase in gross official reserves to US$130 million at end-2007. This increase, however, lagged behind imports, thus resulting in a reduction of the import cover to less than two months. The real effective exchange rate (REER) has depreciated by a cumulative of 24 percent in 2001–07, relative to its 2000 average, reflecting mainly the weakening of the U.S. dollar. Nevertheless, a variety of indicators suggest that competitiveness remains low. Electricity, labor, and other domestic production costs are high, while skill level is low, and the institutional environment is weak.

Program Summary

The program aims at fostering sustainable and balanced economic growth through macroeconomic stability, improved competitiveness, reduced inflation, and a strengthened external position. It focuses on: (i) bringing the overall fiscal position to a balance in the medium term while increasing the share of social and infrastructure projects in total spending; (ii) strengthening financial sector soundness; (iii) improving competitiveness mainly through a reduction in domestic production costs; and (iv) building institutional capacity, particularly strengthening the statistical framework, fiscal transparency, and public sector governance.

The authorities' fiscal policy under the program aims at balancing the budget in the medium term while increasing spending for poverty reduction. The overall deficit (on a commitment basis) would be brought to balance by 2011, while current expenditure on social programs would increase to about 12 percent in 2011. Tax reforms and improvements in tax administration would reverse the decline in tax revenue and bring it back to about 20 percent of GDP by 2011. Additional measures would be adopted to contain current expenditure not related to the poverty-reduction strategy, and the public investment program would be financed mainly external grants and concessional loans. The wage bill would be further contained in the medium term by the reform of the civil service, including completion of organizational and strategic audits.

The new PRGF arrangement implies access to funds amounting to SDR 12.72 million (about US$20 million), corresponding to 80 percent of Djibouti's IMF quota. This access level reflects Djibouti's status as a second-time PRGF user as well as the projected financing needs of the country, taking into account the impact of the food and oil price shocks, and is consistent with Djibouti's projected capacity to repay the Fund.

Djibouti: Selected Economic and Financial Indicators, 2005–09

	2005	2006	Est. 2007	Projections 2008	2009
National accounts					
Nominal GDP (in millions of Djibouti francs)	125,976	136,645	151,033	172,882	195,826
Nominal GDP per capita (in U.S. dollars)	894	946	1,020	1,139	1,259
Real GDP per capita	552	564	579	599	625
Real GDP per capita (annual percentage change)	1.4	2.3	2.7	3.4	4.3
Real GDP (annual change in percent)	3.2	4.8	5.3	5.9	6.9
Consumer prices (annual average)	3.1	3.6	5.0	8.1	6.0
Consumer prices (end of period)	3.5	3.5	8.2	7.5	5.5
Investment and saving	(In percent of GDP)				
Total fixed capital investment	23.2	35.0	42.1	43.7	41.9
Private	13.9	27.5	30.9	33.2	29.7
Public	9.3	7.5	11.2	10.4	12.3
Gross national saving	20.0	20.4	17.3	10.1	9.1
Savings/investment balance	-3.2	-14.7	-24.8	-33.5	-32.9
Budgetary operations					
Total revenue and grants	37.1	34.9	35.1	32.9	34.8
Of which: Tax revenue	20.0	20.3	20.5	18.4	18.6
Expenditure and net lending	36.8	37.4	37.7	34.9	36.6
Current expenditure	27.5	29.9	26.5	24.4	24.4
Capital expenditure	9.3	7.5	11.2	10.4	12.3
Balance (payment order basis)	0.2	-2.5	-2.6	-1.9	-1.8
Domestic financing	-0.3	-0.6	-0.2	-1.0	-1.0
External financing 1/	2.9	2.7	3.3	4.0	4.1
Change in domestic and external arrears (decrease -) 2/	-2.4	0.2	-0.7	-1.1	-1.3
Monetary sector	(Annual change in percent, unless otherwise indicated)				
Net foreign assets	12.0	15.3	4.0	3.7	3.7
Net domestic assets	8.7	-11.9	41.4	47.2	40.6
Claims on the private sector	1.2	9.1	23.1	34.8	28.6
Broad money	11.3	10.2	9.6	12.0	13.0
Velocity of broad money (ratio)	1.29	1.27	1.28	1.29	1.29
Commercial lending interest rate (in percent)	11.7	11.8	11.2	...	...
External sector	(In millions of U.S. dollars, unless otherwise indicated)				
Exports of goods and services 3/	288	312	363	420	503
Imports of goods and services	-391	-489	-641	-815	-938
Current account balance	-23	-113	-211	-326	-362
(in percent of GDP)	-3.2	-14.7	-24.8	-33.5	-32.9
FDI in percent of GDP	8.3	21.3	23.0	24.3	20.5
Stock of external public and publicly guaranteed debt 4/	440	435	504	573	655
(in percent of GDP)	62.0	56.6	59.3	58.9	59.5
Gross official reserves	88	117	130	132	143
(in months of imports of goods and services) 5/	2.2	2.2	1.9	1.7	1.8
Gross foreign assets of commercial banks	431	480	508	528	541
(in months of imports of goods and services) 5/	10.6	9.0	7.5	6.8	6.6
Memorandum items:					
Currency board cover (in percent) 6/	107.6	108.7	116.3	103.5	104.5
Exchange rate (DF/US$) end-of-period	177.7	177.7	177.7	…	…
Real effective exchange rate (annual average; 2000 = 100)	88.8	88.2	84.5	…	…
(End-year change in percent; depreciation -)	-1.1	-0.7	-4.2	…	…

Sources: Djibouti authorities; and IMF staff estimates and projections.
1/ Includes external arrears on amortizations.
2/ Domestic arrears include wage arrears and arrears to private and public suppliers for goods and services, to the pension fund, and to public enterprises. External arrears include arrears on interest only (arrears on principal are counted as an item of "external financing").
3/ Unlike the May 2007 staff report, cattle reexports for 2006 and 2007 are recorded on net basis.
4/ Includes external arrears and debt owed to Italy and Spain.
5/ In months of the following year's imports.
6/ Gross foreign assets of the CBD, in percent of monetary liabilities (reserve money and government deposits at CBD).

Statement by Laurean Rutayisire,
Executive Director for Djibouti
September 17, 2008

I - Introduction

I would like to express the deep appreciation of my Djiboutian authorities to Management and Staff for their support and for the constructive policy dialogue during the recent discussions on the 2008 Article IV consultation and the new program supported by an arrangement under the PRGF.

Notwithstanding the adverse impact of the surge in global prices of oil and food and the tension at the border with Eritrea, my Djiboutian authorities have made commendable progress towards preserving macroeconomic stability and laying out required conditions for a successful implementation of a new PRGF-supported program. Economic growth accelerated in 2007 driven by large foreign direct investments. External competitiveness improved through further real effective depreciation of the Djiboutian franc and key structural reforms were implemented, notably, the enforcement of a new labor code, the physical audit of the civil service, and the adoption of a PRSP prepared in collaboration with the World Bank and the Fund.

High oil and food import price shocks have had severe impact on Djibouti's cost of living. In response, the authorities introduced temporary measures to eliminate consumption taxes on five basic food staples and reach agreement with importers and retailers to cap their profit margins on these food items. However, going forward, my Djiboutian authorities are strongly committed to continue their efforts in maintaining macroeconomic stability, stimulate foreign and domestic investment, expand growth, create jobs, reduce poverty and accelerate structural reforms. In order to strengthen their efforts, my authorities are requesting a three-year arrangement under the PRGF. The well documented debt sustainability analysis has underscored the high risk of debt distress Djibouti is facing. My authorities are hopeful that a successful implementation of the new PRGF-supported program will help mobilize the support of their development partners, advance in structural reforms, improve competitiveness and sustained higher economic growth.

II - Recent Macroeconomic Developments

The stable political situation and foreign investments flows in 2006-07 have led to significant improvements in macroeconomic performance. Real GDP accelerated to 5.3 percent in 2007 from 4.8 percent in 2006 thanks to investments in the construction and port services sectors. The overall fiscal deficit remained at about 2.5 percent with a basic fiscal deficit narrowing from 7.2 percent in 2006 to 4.9 percent in 2007 as the current expenditure declined to 26.5 percent in 2007 from 30 percent in 2006. However due mainly to the increase in imports financed by foreign investments and the surge in food and oil prices, the current account deficit stood at about 25 percent and was more than offset by the large capital and financial account surplus. The gross official reserves increased to USD 130 million or to a currency board cover of 116 percent. The credit to the private sector also increased by 23 percent in 2007 after being stagnant over the past years.

The strong commitment of my Djiboutian authorities to improve the competitiveness of the economy has translated into significant progress in implementing structural reforms. The reform of the civil service has advanced with the completion of the physical audit and the establishment of a single registry of civil servants. A new labor code came into force. The reform of the social safety system was implemented by merging two of the three pension funds. The computerization of the expenditure chain was finalized. The audited financial statements of public enterprises for 2004 and 2005 were published on the website of the ministry of finance in December 2007. This practice will continue by publishing the 2006 audited statements in 2008. The authorities announced in the 2008 budget law the introduction of the VAT early 2009 and also adopted the proposed measures for this introduction including an action plan. Progress has also been made in unifying and simplifying the system of tax exemptions by merging the various preferential tax regimes. With regard to the anti-money laundering, an assessment of the system in place was conducted by the Fund's Legal Department. In addition the Central Bank of Djibouti benefited also Fund's technical assistance in implementing the international financial reporting standards (IFRS).

My Djiboutian authorities are fully aware on the urgent need to improve the competitiveness of the economy by lowering domestic production costs and preserving macroeconomic stability. They are determined to pursue the implementation of structural reforms and strengthen the regulatory framework for the development of the private sector seen as an engine of growth and job creation in order to alleviate poverty. To this end my authorities intend to further mobilize the support of their development partners and will organize a donors' conference in November 2008.

III - Medium-Term Program and Policies for 2008-09

The medium-term economic and financial strategy under the PRGF supported program is consistent with the National Initiative for Social Development (INDS) launched in January 2007. This strategy aims at (i) placing the economy on a path of sustainable growth to reduce unemployment, mitigate poverty and improve social indicators; (ii) ensuring domestic financial stability by controlling inflation; (iii) increasing competitiveness and maintaining prudent management of foreign indebtedness; (iv) improving fiscal management and transparency and (v) strengthening administrative and institutional capacity.

In implementing this strategy my Djiboutian authorities intend to take full advantage of the country's political stability, strategic position on the most used sea route, the currency board arrangement and its participation in the Common Market for Eastern and Southern

Africa (COMESA) to modernize and develop the economy and transform Djibouti into a regional trade and services hub.

Fiscal Policy and Debt Sustainability

The authorities are strongly committed to improve fiscal management and implement their poverty reduction strategy. In this regard, they will strengthen revenue mobilization, streamline public expenditure and increase fiscal transparency. In particular, the overall fiscal deficit, on a commitment basis will be reduced from 2.6 percent of GDP in 2007 to 1.9 percent in 2008 and to 1.8 percent in 2009. In order to meet this target, the authorities have initiated strong measures to increase tax revenue and reduce non priority current expenditure.

On the revenue side, based on progress made in modernizing tax administration and establishing the unified integrated tax department, the authorities will introduce in January 2009 a value- added tax (VAT). The VAT will coexist with the sales taxes (TIC) until the introduction of the external common tariff (TEC) under the COMESA arrangement. The VAT will be applied at a single general rate of at least 7 percent and will yield net revenue equivalent to 1.1 percent of GDP in 2009. In addition, a set of measures to promote taxpayer compliance, simplify the tax system and broaden the tax base while consolidating the tax administration will also be implemented. The investment code will be revised by end-February 2009 with a view to streamline tax exemptions and strengthen the procedures and resources for monitoring exemptions.

On the expenditure side, the authorities aim at increasing the effectiveness of public spending and cash management. In this regard, the government accounts through the banking system will be merged into a single Treasury account by end-May 2009. FAD recommendations in the areas of budget classification and preparation of a comprehensive medium-term budget framework will also be implemented in 2009. In order to reduce average purchase costs by achieving large economies of scale, the public procurement of government departments is to be centralized as of August 2008. The stock of domestic payment arrears will also be reduced by 2.5 percent of GDP in 2008-09.

The authorities welcome the conclusions of the debt sustainability analysis conducted by the Fund and the World Bank which indicates that Djibouti's risk of debt distress in the short term continues to be high despite some improvement in the medium-term projections. External and total government debt are estimated respectively at 59.3 percent and 62 percent of GDP in 2007 including arrears. As regards external arrears, the authorities will negotiate shortly a debt restructuring agreement with the Paris Club. They are also determined to avoid the accumulation of further arrears and intend to improve debt management practices through appropriate technical assistance. Furthermore, they will avoid contracting or guaranteeing nonconcessional loans and will also ensure that public enterprises do not borrow on non concessional terms.

Monetary Policy and Financial Sector Issues

The authorities reaffirm their commitment to maintain the currency board arrangement as it has served to enhance confidence in the Djiboutian franc and banks and remain essential to attract investments. The recent food and oil price shocks have pushed inflation whose impact was partially contained through temporary measures. The authorities are of the view that in the context of a currency board, efforts to contain inflation should focus on fiscal restraint and on reforms aimed at alleviating capacity constraints and fostering competition. The central bank intends to introduce in 2009 after consultation with banks and technical assistance from the Fund, the reserve requirements on deposits to mop up excess liquidity from the banking system and contribute to price stability. The introduction of this new monetary instrument within the framework of the Banking Law will preserve the profitability and financing capacity of the banking system.

The competition within the banking system has been increased with the establishment of three new banks. It has also led to lower intermediation spreads and new banking services. To enhance the integrity of this expanding banking system, the Central Bank will strengthen its supervisory capacity in accordance with the Basle principles. In the same vein the required minimum capital of banks will be doubled in 2009 from DF 300 million to DF 600 million. Moreover, the authorities are looking forward to the recommendations of the FSAP mission assigned to highlight the vulnerabilities of the new financial system and enhance its role as a catalyst for economic growth. Recommendations made by the recent IMF Legal Department in the area of AML/CFT will be fully implemented to raise awareness and increase the effectiveness of the monitoring in the public and private sectors.

Structural Reforms and Competitiveness

The authorities will step up their efforts to further advance in implementing the structural reforms which remain critical to improve Djibouti's external competitiveness and foster growth and alleviate poverty. In addition to fiscal and financial reforms, the authorities will also enhance the legal and regulatory framework for business through in particular the submission of the new Commercial Code to the National Assembly by end-November 2008 and streamlining the creation for the creation of enterprises under the coordination of the one stop shop at the National Investment Promotion Agency (ANPI) with departments concerned with private investment.

In order to further reduce the costs of production factors, efforts aiming at restructuring and fiscal consolidation of Djibouti-Telecom, ONED and EDD will be enhanced with a view to improve the quality of their services, ensure their financial viability and increase their productivity. With regard to electricity supply in particular, the authorities intend to develop alternative sources. A major agreement was signed with Ethiopia to enable the import of electricity from that country. The new labor Code will be complemented by the adoption of the remaining implementing decrees by end-May 2009 and by end-August renegotiate all collective bargainings agreements.

The authorities are fully aware on the need to strengthen governance and transparency to improve the business climate. In this respect, the General Inspectorate of Finances will be further enhanced with its restructuring and continuously building of its capacity.

On the external front, the authorities are determined to maintain the existing free trade system. The COMESA's common external tariff will be adopted as soon as an agreement is reached by the member countries on the applicable rates and other technical aspects meeting the WTO requirements.

The authorities' efforts to improve the quality and timeless of statistic will continue. My authorities are grateful to their development partners for the technical assistance provided in this area. They intend to carry out by end-February 2009 a full population census which will be followed by a comprehensive household expenditure survey with a view to revise the weights used in the CPI basket, update various social indicators and provide new poverty and income distribution estimates.

IV - Conclusion

My Djiboutian authorities are determined to pursue the implementation of sound policies and far-reaching structural reforms to sustain economic growth, increase job creation and make significant inroads in achieving the MDGs. To supplement their efforts, a sustained assistance from the international community is needed. In this regard, my authorities are requesting Fund support through a PRGF arrangement.