International Monetary Fund

Djibouti and the IMF

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Djibouti: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

May 9, 2012

LETTER OF INTENT
AND MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

Djibouti, May 9, 2012

Madame Christine Lagarde
Managing Director
International Monetary Fund
Washington D.C. 20431

Madame Managing Director,

1. This Letter of Intent is to inform you of the progress made by Djibouti in 2011 and in the first months of 2012 in the context of the Extended Credit Facility (ECF). It also sets out the government's intentions in the area of economic policy and the planned reforms for the remainder of 2012.

2. The objectives of the ECF-supported program remain unchanged. These objectives are consistent with our goal of making Djibouti a hub of trade, logistics and related services, and financial services. The ECF-supported program will remain aligned with the National Social Development Initiative (INDS) and is based on our national economic development and poverty reduction strategy.

3. Program implementation suffered significant disruption in 2011 owing to the exceptional drought conditions. More than 12 million people (11 percent of the population) in the Horn of Africa were affected by one of the worst droughts in 60 years, resulting in the loss of harvests and cattle. Djibouti was among the worst affected countries, along with Ethiopia, Kenya, and Somalia. In 2012, the government of Djibouti and its partners still assist more than 106,000 people and the more than 22,000 refugees who have continued to arrive. This assistance includes general food distribution and targeted supplementary feeding programs aimed at reducing and stabilizing cases of acute malnutrition, particularly in the country's five rural districts, where the persistent drought conditions have continued to exacerbate an already acute food security situation. With support from its partners, actions have focused on the rehabilitation of assets lost during the drought (restocking of herds) and on new activities designed to strengthen resilience to future shocks, such as access roads, soil and water conservation and rehabilitation, fruit and vegetable farming, and tree planting. Nonetheless, according to UNICEF, the number of new cases of malnutrition among children aged 6 to 59 months has continued to rise, and some 14,000 primary school children in rural areas are enrolled in school feeding programs. Based on available data, around 33 percent of Djiboutians still live in high-risk areas, and 35.3 percent of the economy is vulnerable to natural risks.

4. Against that backdrop, our partners have committed to providing us with aid amounting to a total of US$65 million to assist us in dealing with this emergency situation. We have set up an interministerial drought crisis committee chaired by the Minister of the Interior, assisted by the Ministry of Finance and the Solidarity Secretariat in coordination with donors, including the IMF. Some payments on these commitments were already made in 2011, and the remainder is expected in 2012 and 2013. Most of this aid is expected to take the form of in-kind donations channeled mainly through the World Food Program (WFP).

5. The adverse effects of the drought are in addition to the strong surge in international prices of petroleum products and, more particularly, food in 2011, which have hit hard the population. To meet the exceptional financing needs resulting from these shocks, we have requested and obtained from your institution an augmentation of access to ECF resources of 60 percent of quota (SDR 9.54 million).

6. Owing to delays in the finalization of preparations for the review, it was not possible to modify the quantitative criteria for end-2011 agreed with Fund staff in the context of discussions on the fifth review. Thus, end-of-year performance will have to be assessed on the basis of the targets outlined in the Letter of Intent of January 2011, which will require waivers for failure to meet the performance criteria for technical reasons, over and above the limited deviations from the targets described below.

7. In respect of the targets agreed with Fund staff, the program remains on track, with an actual budget deficit of 0.7 percent, which is in line with the target of 0.4 percent, taking into account the program adjustments. Rigorous expenditure control in 2011 made it possible to control overall fiscal performance, which had suffered from weak collection of tax and nontax revenues during the first half of the year. However, net credit to the government deviated from the adjusted target by about 0.2 percent of GDP as a result of the faster-than-expected pace of clearance of domestic arrears (Table 1). We also accumulated small amounts of domestic arrears due mainly to delays in social security payments. The other indicative quantitative performance criteria and targets for end-December 2011 were observed. Further, no nonconcessional debt has been contracted either in 2011 or over the course of 2012.

8. Most of the structural benchmarks for 2011 and 2012 have now been completed (Table 2), with the exception of: (i) the acquisition of a software program for budget reclassification (*structural benchmark for end-December 2011*), and (ii) preparation of the list of enterprises whose exemptions have been suspended for failing to file their tax returns (*structural benchmark for end-March 2012*).

9. To achieve the objectives of the ECF, our program for 2012 continues to hinge on: (i) the pursuit of prudent fiscal policy consistent with the safeguarding of social expenditure; (ii) the strengthening of fiscal management; (iii) the maintenance of debt sustainability;

(iv) the modernization of the financial sector; and (v) the enhancement of the competitiveness of the economy through the deepening of structural reforms.

I. Economic Developments in 2011 and Outlook for 2012

10. Djibouti's economy is estimated to have grown by 4.4 percent in 2011, compared to 3.5 percent in 2010, boosted by the resumption of transshipment activity, the stabilization of the situation in Ethiopia, and intensification of the services sector, particularly banking and telecommunications (mobile telephony and internet). In 2011, inflation reached 5.1 percent, owing to the significant rise in world food and fuel prices. Competitiveness, measured by the effective exchange rate, deteriorated from 2008 to 2010 as a result of the appreciation of the Djibouti franc against the euro. The trend was reversed in 2011 because of the decline in the US dollar and the positive differential between domestic inflation and inflation rates in Djibouti's main trading partner, Ethiopia.

11. The current account deficit is estimated at 12.6 percent of GDP in 2011, up from 5.8 percent of GDP in 2010, driven by the increase in imports stemming from the impact of the drought and by the surge in world food and fuel prices. As a result of this increase, weak fiscal performance, and a resumption of FDI less vigorous than expected, reserves remained broadly unchanged at $228 million in 2011, guaranteeing adequate coverage of the currency board and imports. The stock of external debt is estimated to have declined from 56 percent of GDP at end-2010 to 55 percent at end-2011. The strong trend in credit and deposit growth seen in recent years was reversed in 2011, owing in part to election-period uncertainty, and to the situation of one bank which was changing ownership. Credit to the private sector recorded a positive growth, but deposits fell, resulting in a 5 percent fall in the money supply.

12. Growth is expected to rise to 4.8 percent in 2012, owing mainly to expanding port, construction, and service activities as well as increased FDI. Inflation is projected to fall to 4.3 percent as world food prices stabilize and electricity rates decline. Imports will continue the upward trend we saw in 2011 as a result of the impact of the drought and the rise in FDI flows. Consequently, the current account deficit is set to stabilize at a high level of 12.1 percent of GDP. However, significant capital flows should drive reserves up to $245 million, while, buoyed by the rebound in activity, monetary variables are expected to accelerate.

II. Government Finance

A. Fiscal policy

13. Our fiscal policy remains focused on three key areas, namely: fiscal rebalancing to maintain debt sustainability and nonmonetary financing of fiscal deficits; the safeguarding of fiscal space for social expenditure; and the strengthening and modernization of fiscal management.

2011 Fiscal performance

14. Fiscal performance for 2011 remained close to the targets discussed during the mission for the fifth review of the ECF.

- Collection of direct and indirect taxes was slowed by the election period, installation of the new government, and reorganization of the fiscal administration. Revenues also suffered from the indirect impact of the drought on households, including through transfers to family members, often residing in neighboring countries such as Somalia, and the contribution of private operators to solidarity efforts. In addition, owing to the steep spike in international prices, we were obliged to post losses on the petroleum price adjustment factor (*redevances*) for diesel needed to offset the impact of higher oil prices on the most vulnerable sections of the population.

- Expenditures, more particularly transfers, have been strictly controlled, so as to limit the deficit. We maintained the freeze on hiring and wages in the public sector, except in the education and health sectors.

15. In the context of the repayment of domestic arrears accumulated before 2003, we finalized the reconciliation of cross debts. On this basis, we doubled the programmed amount of settled domestic arrears to facilitate the financial consolidation process in the state-owned enterprises ONEAD, Djibouti Telecom, and EDD. This early repayment was financed domestically through financing from the BCD and the BCI (in the form of advance dividends). In 2011, we did not carry out any extrabudgetary spending and are committed to avoid any such spending in the future. We accumulated small amount of domestic arrears (between 0.01 and 0.09 percent of GDP) in December 2011, and January and February 2012, mainly due to delays in social security payments.

Fiscal policy for 2012

16. The need to strengthen the government's financial position has compelled us to go beyond the target set in the 2012 Budget Law, which envisaged a balanced budget. We envisage now a surplus of 0.5 percent of GDP. This revised target, to be formalized in the revised budget, is designed both to facilitate reconstitution of government deposits at the BCD and BCI, which declined following the scheduled repayment of domestic arrears in 2011, and to continue the domestic arrears clearance. To the extent possible, the repayment of arrears could be accelerated in the event of more robust revenue performance.

- We expect revenues to exceed 2011 levels, thanks to reform of the VAT and of exemptions as well as to the stepping-up of our tax collection efforts through more effective onsite and offsite inspection. We have included in the 2012 budget the lowering of the VAT threshold from DF 80 million to DF 50 million (*structural benchmark for December 2011*). The 2012 budget law provides for a tax of DF 3 per kilowatt/hour imported from Ethiopia to offset forgone domestic consumption tax

(TIC) revenue as a result of fuel savings made possible by the interconnection. In addition, the U.S. armed forces that were exempt from the pump prices equalization mechanism in 2011 will now pay an annual lump sum of $8 million.

- We will seek to raise our investment spending in sectors with growth potential, while pursuing fiscal restraint. In this context, we will maintain the hiring freeze in the public service, with the exception of the social sectors, in particular, education and health. We also intend to maintain the public-sector wage freeze. At the same time, we have increased wages on the lowest levels of the public-service pay scale to fight poverty by catching up with the cumulative loss of purchasing power of the lowest-paid employees. We are committed to reduce spending, in particular on domestically-financed expenditures, in the event of an underperformance of revenues.

Subsidy policy

17. To address the rise in fuel and food prices, we put in place subsidies to mitigate the effects on the most vulnerable population groups.

- Regarding the energy sector, in 2012 we plan to pursue our policy of stabilizing the diesel price by reducing both the pump price adjustment (*redevances*) and the surcharge. Thus, the 2012 budget law projects a revenue shortfall of around DF 92 million compared to potential revenues, despite the gradual but steady rise in pump prices since October 2011, amounting to a total of DF 10. Mindful that, given its budgetary constraints, the government cannot afford to continue absorbing a loss of this magnitude, we have launched a study, with the assistance of the IMF, on the introduction of social safety nets for vulnerable sectors (such as public transportation, taxis, and bakeries). We have also set the price of kerosene at a level affordable by the most vulnerable segments of the population through a subsidy of around DF 60 million for 2011.

- Regarding the food security situation, under further pressure from the drought, we count on cereal production (of around 8,000 metric tons in 2010 and 7,500 metric tons in 2011) grown in Ethiopia and Sudan and managed by the Djiboutian Food Security Company. This production is sold on the local market at subsidized prices, with the objective of stabilizing local food prices, at a budgetary cost of around DF 100 million. In the interest of increased transparency of the subsidies, we plan to prepare a summary balance sheet for FY 2010 of the food security program by end-2011. We will disclose the operating accounts of the food security company to Fund staff.

18. One of the major challenges we are facing is unemployment, which affects a significant share of our active population, and in particular, young people. With a view to achieving greater alignment between training and employers' needs, the National Education

Ministry is currently preparing a training strategy that is more targeted towards mid-level technical training programs. We have also opened a logistics training center to promote training in the skills needed to fill high-technology jobs on the port and in the transport and energy sectors. To facilitate the employment of young graduates outside the public sector, we have established a youth employment promotion fund and, through the national budget, we are financing a loan initiative for business creation. Further, we have put in place a guarantee fund for loans granted within that framework. In addition, some foreign companies operating in the country have been offering selective skills training programs abroad, to meet their own operational needs.

B. Fiscal Reforms

19. In light of the reorganization of the Ministry of Finance with an expanded scope of activities and to ensure better coordination of the actions necessary for implementation of the ECF-supported program, under the authority of the Secretary General, we have established a macroeconomic unit that has taken on the functions of the committee for program coordination. The unit will be responsible for macroeconomic analysis, follow up, within the agreed timeframes, of the program reporting documents, monitoring of the targeted program variables, and preparation of a reference macroeconomic framework for the Ministry of Finance.

Direct and indirect taxes

20. To improve the management of direct and indirect taxes, we plan to (i) strengthen the coordination between the entities responsible for managing the VAT and direct taxes through the extension, already in effect, of the single taxpayer identification number (NIF) to include enterprises subject to the declaration of direct taxes as well as to other taxpayers; (ii) strengthen the functionality of the tax center opened in 2011 in the Balbala district consistent with the policy of equipping each major region of the country with similar centers (the two regional treasuries in Ali Sabieh and Tadjourah will soon come on stream) in the context of decentralization. We have completed the full rollout of the customs revenue management software ASYCUDA *(structural benchmark for end-December 2011)*. The system now incorporates the NIF through an interface with the general tax directorate, thus improving taxpayer identification.

21. We are committed to continuing to reform the system of exemptions and, to that end, we intend to: (i) strictly apply the law, as a first step; (ii) introduce a requirement for all enterprises granted exemptions to file tax returns or face suspension of their exemptions in case of noncompliance; and (iii) assign the necessary staff to estimate the tax expenditure of the government and draft a report on tax expenditure, which will be annexed to the 2012 supplementary budget. The previously established coordination committee is to be disbanded since the various entities (ANPI, tax, customs) that deal with exemptions now fall under the authority of the Ministry of Finance. We have not yet revoked the tax exempt status of those

enterprises that failed to file their tax returns *(structural benchmark for end-March 2012).* To that end, we will compile in the coming weeks a full, updated list of enterprises granted exemptions, which we intend to review on a regular basis and publish on the website of the Ministry of Finance.

22. In the context of fiscal reform, we intend to continue our reflections on the tax system in Djibouti, in particular during the tax forum scheduled for June 2012. Our aim is to bring together the various national actors concerned, policymakers, operators and partners, to devise a tax strategy that could help boost the economy, for instance by focusing on the taxation of small and medium enterprises and by reviewing the taxation of large enterprises, as well as revising the system of exemptions.

Expenditure control and public financial management

23. In 2012, we plan to continue efforts to control public finance management by pursuing (i) a policy of transferring the balances of government accounts and of donor-financed project accounts to the treasury single account; (ii) the preparations for the establishment of a medium-term budget framework for the 2013 budget, with technical assistance from our partners, in particular the IMF and UNDP; (iii) continued publication of the monthly fiscal reporting table (TOFE) on the Ministry of Finance website within a maximum of two months (*continuous structural benchmark*); and (iv) efforts to apply the new budget classification. The acquisition of the budget nomenclature software (*structural benchmark for end-December 2011)* has been delayed once again because of the delays of our development partners in confirming their financing. We have, however, identified a potential supplier to install an integrated management system, to which the budget classification software could be added, and which could hopefully be installed by early 2013.

Arrears and cross debt

24. We remain determined to reduce the stock of domestic arrears still outstanding, including those accumulated in 1995–2001, and to prevent further accumulation, despite the absence of assistance from donors. After finalizing the recalculation of cross-debt, in 2011 we proceeded with the early repayment of DF 4,200 million in domestic arrears accumulated between 1997 and 2001 and reconciled in 2003. Based on the original timetable, the payment should have been completed in 2013. However, because of liquidity constraints, the annual repayment schedule was not always respected in past years. The balance outstanding, therefore, stands at DF 9.9 billion instead of the DF 4.4 billion initially projected. Taking into account our fiscal resources, we undertake to repay this amount over a maximum of 5 years, giving precedence to private suppliers and public enterprises. A preliminary schedule is annexed.

25. To avoid further accumulation of arrears, we will: (i) continue to implement controls on the public expenditure chain so as not to accumulate further arrears with the exception of those attributable to the one-month lag in the payment of public wages and the three-month

lag in social security contributions, which we intend to reduce depending on the availability of resources; (ii) monitor, on a regular basis, the situation of domestic arrears and the execution of payments to public utilities (which will be reported to Fund staff on a quarterly basis) in the context of the bi-monthly treasury planning exercises; and (iii) continue to remain prudent in our budget appropriations for spending related to external financing for which agreements have not yet been signed.

III. External Debt

26. Progress in relations with the Paris Club creditors has facilitated the conclusion of bilateral agreements and the entry into force of the second phase of the agreement concluded in October 2008. In accordance with the clause of comparability of treatment under the Paris Club agreement, we have signed bilateral agreements with Saudi Arabia and have approached the United Arab Emirates and Kuwait to begin negotiations with a view to obtaining treatment comparable to the Paris Club agreement.

27. Given the strained liquidity situation in the first half of 2011, more external arrears were accumulated in the course of 2011 by the government and some public enterprises vis-à-vis multilateral and bilateral creditors, including Paris Club members. These arrears were settled in the course of the last quarter of 2011. We undertake to avoid any future accumulation of external arrears, including from public enterprises, and, to that effect, we have strengthened the monitoring of debt service payments, in particular through systematic verification with creditors of the actual execution of such payments, and we will also ensure regular transmission of the monthly debt service reports to the IMF.

28. To preserve debt sustainability, we will continue to contract only concessional loans and to establish an order of priority of projects to be financed under the INDS, paying particular attention to major infrastructure projects under negotiation, even beyond the end of the current ECF arrangement. In that context, under the leadership of the Ministry of Finance, we have improved coordination between the various ministerial departments in the context of the government's financing programs as well as the related policies and actions. We have also extended to public enterprises the requirement to avoid contracting nonconcessional debt.

IV. Monetary and Financial Policies

29. Our monetary policy continues to be underpinned by the currency board arrangement, which is consistent with the structure of our economy by ensuring price stability. We undertake to continue to ensure coverage of all our foreign currency-denominated liabilities and maintaining a rate of coverage higher than 105 percent of reserve money and government deposits with the BCD. Our external position is bolstered by the absence of encumbrances on our foreign-currency reserves, and we are committed to pursuing this prudent policy.

30. The recent strong growth in the banking system has increased risks. Nevertheless, despite the slight increase in 2011 of nonperforming loans, financial soundness indicators remained positive at end-2011. In anticipation of potential vulnerabilities, we remain firmly committed to implementing our reform program in accordance with the broad guidelines of the Financial System Assessment Program (FSAP). In that context, we have strengthened banking supervision, and will closely monitor any changes in the financial soundness indicators. The banking system will also be strengthened through the implementation of laws that have recently been passed or amended, notably the raising of the minimum capital requirement, which will be tripled to DF 1 billion over a maximum period of three years, and the tightening of conditions for the granting of new licenses, on which we have imposed a de facto suspension to avoid overcrowding in the financial system. We also intend to request a new FSAP in the coming months.

31. In addition, we are preparing for the upcoming introduction of reserve requirements, which will be an important new liquidity management tool for the BCD. Similarly, we plan to equip the central bank with a foreign currency cash flow forecasting tool to facilitate the efficient monitoring of the evolution of its foreign exchange reserves.

A. Banking Supervision

32. We conducted on-site inspection of five banks and one microfinance institution in 2011 and plan to inspect five banks, five auxiliary financial institutions, and two microfinance institutions in 2012 (three auxiliary financial institutions have already been inspected). We will also carry out continuous offsite supervision of banks, and are currently in the process of revising the charter of foreign exchange bureaus to bring it into compliance with the new banking law. Further, all banks now submit their internal audit reports as well as their monthly financial statements, thus allowing for the identification of credit, liquidity, and foreign exchange risks. We have also tightened the imposition of penalties on banks that fail to meet the requirement of regular disclosure of their financial statements. These data, provided regularly by banks, will enable us to compile financial stability indicators on a quarterly basis. For improved oversight of portfolio quality, the reporting threshold for nonperforming loans has been lowered.

33. We have developed a roadmap, based on a precise timetable, for implementing the laws approved in 2011. Preparation of the enabling texts of the banking law and supervision instruments has been completed and the new instructions adopted in December 2011 have been issued. In the coming months, we expect to adopt additional new instruments, particularly on liquidity, with technical assistance from the IMF.

B. Financial Sector Development

34. We intend to pursue our efforts to develop the financial sector and access to finance. With the help of our development partners (World Bank, African Development Bank, Islamic Development Bank, and UNDP), we will continue to work to (i) improve access to

microfinance for individuals and small and medium enterprises by setting up a dedicated unit at the CBD; (ii) improve the management of existing structures, such as the central credit register, and lay the groundwork for transitioning to a credit bureau; (iii) facilitate mobile banking transactions; and (iv) strengthen the payment system.

C. Governance of the Central Bank of Djibouti

35. To ensure the integrity of the CBD's operations, we are in the process of implementing the recommendations of the safeguards assessment mission and, in November, we hosted another similar mission in the context of the augmentation of access under the ECF. Starting with the financial report for 2010, the financial reports will be completed within six months of the end of the financial year as will the audit opinion. The full financial statements for 2010, including the audit opinion and the general information notes, have been published on the website of the CBD (*structural benchmark for end-December 2011*). We have strengthened internal control by updating our procedures. In September 2011, pursuant to our commitments, the Board of Directors adopted an official timetable of quarterly meetings and expanded its functions (*structural benchmark for end-June 2011*), including providing for the establishment within the Board of an audit committee responsible for overseeing internal control. An audit charter is under preparation.

D. Combating Money Laundering and Terrorism Financing

36. We are currently addressing the weaknesses in the area of combating money laundering, and terrorism financing through an amendment of the law on combating money laundering and two separate draft laws on the prevention of terrorism and the financing of terrorism, respectively, adopted in 2011. The BCD is currently considering long-term technical assistance in this area, to be financed by donors.

V. Competitiveness and Structural Reforms

37. Because of the currency board arrangement, Djibouti's attractiveness for investment depends essentially on the competitiveness of the economy, which is still hampered by the high costs of the principal factors of production and the weaknesses associated with the business climate. Accordingly, we are strongly committed to pursuing our program of structural reforms, which are aimed especially at reducing energy and water costs, restructuring public enterprises, and improving the legal and regulatory framework. The investment and commercial codes and the law on industrial property, as well as the labor code, are now fully in effect.

38. We are pursuing the reforms in the energy and water sectors. Interconnection with Ethiopia's electricity grid is now completed and, on average, covers more than 50 percent of current consumption in Djibouti at very favorable rates. This has enabled us to reduce electricity rates by 30 percent for low-consumption households, which comprise 60 percent of consumers. In the months ahead, we plan to update the energy master plan with a view to

clarifying our strategy and dealing more vigorously with the technical deficiencies of the EDD, while providing it with the tools to strengthen its management. Further, with support from the World Bank we are preparing to launch in the second half of 2012 a study aimed at assessing the various options for developing geothermal energy. We also implemented the recommendations of the study on the restructuring and reorganization of human resources for the EDD carried out by IDEA Consulting, which in recent years has led to a wage freeze at 2008 levels. Lastly, in the water sector, ONEAD is considering a large seawater desalination investment program to be financed by donors (with support from the EU).

VI. Data

39. The still-low quality of the statistical database continues to hamper our efforts to formulate and monitor economic policies. In January 2012, we joined the General Data Dissemination System and, with the support of our development partners, we are seeking to improve the quality, coverage, and timeliness of economic data, especially in the areas of national accounting, balance of payments, and government finance, using the new legal framework for the organization of statistical activity and the National Statistics System as a basis. With regard to the statistics base, in 2009, we completed the general population census. With support from our development partners, we expect that the survey of economic activities, which will provide data for the estimation of the national accounts, will be completed in 2012. A harmonized consumer price index is being finalized within COMESA and will be applied following the household consumption-budget survey set to begin in the first half of 2012.

VII. Conclusion

40. So as to pave the way for a possible new arrangement following the present ECF, we undertake over the coming months to (i) achieve the indicative targets for the budget balance and net banking system credit to the government, external and domestic arrears for June and December 2012, on the basis of the agreement with Fund staff and the attached Technical Memorandum of Understanding (TMU), (ii) observe the zero ceiling on nonconcessional debt contracted by the government or public enterprises, also pursuant to the TMU, and (iii) complete before the start of a new program, the structural benchmarks relating to the acquisition of a software program for budget nomenclature (*structural benchmark for end-December 2011*), and the preparation of the list of enterprises whose exemptions have been revoked for failing to file their tax returns (*structural benchmark for end-March 2012*).

41. On the basis of the understandings reached with Fund staff in the context of the fifth review, and endorsed by the IMF Executive Board, the program objectives at end-2011 have been met, with the exception of net credit to the government, which deviated from the revised target by 0.2 percent of GDP. However, since it was impossible to modify the performance criteria for end-December 2011, we request waivers for the nonobservance of the criteria at end-December 2011 relating to the budget balance and net banking system

credit to the government, and for the continuous performance criteria on nonaccumulation of domestic arrears, given the overall performance under the program and the policies stated in this Letter. We request the conclusion of the sixth and last review of the ECF with the disbursement of an amount of SDR 1.476 million and the second tranche of the augmentation of access under the ECF, for the amount of SDR 4.77 million.

42. The government believes that the policies and measures stated in this letter are sufficient to achieve the objectives of the ECF arrangement. We shall quickly take all the additional measures necessary for achievement of the program objectives. We shall consult with IMF staff at our own initiative or that of the IMF staff before adopting such measures or changes to the policies specified in the attached MEFP. We shall provide the IMF with any information it may request regarding progress made in implementation, within the framework of its economic and financial development policies and the achievement of the objectives of the program.

Yours sincerely,

/s/	/s/
Ilyas Moussa Dawaleh	Djama M. Haïd
Minister of the Economy and Finance,	Governor
Responsible for Industry and Planning	Central Bank of Djibouti

Table 1. Djibouti: Quantitative Performance Criteria and Indicative Targets, 2011–12 1/

(In millions of Djibouti francs; unless otherwise indicated)

(Cumulative flows)

	2011											2012				
	Jun. 30			Sept. 30		Dec. 31						Mar. 31		Jun. 30	Sep. 30	Dec. 31
	Performance Criteria			Indicative Target		CR/12/169 Performance Criteria			Revised Targets			CR/12/169	Revised Targets	Indicative Targets		
	Prog.	Adj. Prog.	Prel. Act.	Prog.	Prel. Act.	Prog.	Adj. Prog.	Prel. Act.	Prog.	Adj. Prog.	Prel. Act.	Prog.				
Performance Criteria																
I. Ceiling on accumulation of new domestic arrears 2/ 3/	2,260		2,629	2,135	…	2,279		2,290	2,279		2,290	2,279	2,279	2,417	2,417	2,417
II. Ceiling on accumulation of new external arrears 3/ 4/	0		176	0	165	0		0	0		0	0	0	0	0	0
III. Ceiling on net credit to government from the banking system	488	-1,817	-549	-2,015	…	-2,600	-159	2,187	-779	1,717	2,187	9	-1,845	1,761	-3,019	-2,616
IV. Floor on government budget balance (ordonnancement)	-2,628	-99	-378	-1,903	…	883	-692	-1,523	-938	-2,567	-1,523	-85	6	-675	-1,494	1,083
V. Ceiling on new medium- and long-term nonconcessional loans contracted or guaranteed by the government and by the CBD 3/	0		0	0	0	0		0	0		0	0	0	0	0	0
VI. Floor on currency board cover 3/ 5/	105		116	105	150	105		117	105		117	105	105	105	105	105
Indicative targets																
I. Floor on social spending	6,541		5,570	10,024	8,210	14,451		13,474	12,829		13,474	…	…	…	…	15,574
Memorandum items 1/ :																
Adjuster No.1 Projected French, U.S., and Japan military base payments	4,024		6,373	7,154	6,995	12,736		10,554	12,736		10,554	6,350	5,954	6,458	8,490	10,268
Adjuster No.2 External budgetary grants and loans	504		416	2,548	621	3,228		2,709	3,337		2,709	650	868	411	616	3,472
Adjuster No.3 Externally financed public investment loans (PIP)	3,228		3,004	4,466	5,043	6,815		5,948	6,815		5,948	1,935	1,384	2,946	4,945	6,683

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

1/ See the Technical Memorandum of Understanding for definitions and adjustor calculations.

2/ Represents a rolling stock expressed in terms of one month's wages or and three months' pension fund contributions. Hence it may vary over time.

3/ To be impemented on a continuous basis.

4/ Includes arrears on direct and guaranteed debt, continuous.

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

Table 2. Djibouti: Structural Benchmarks Under the Extended Credit Facility (ECF)

Measures	Date	Motivation	Status
Structural benchmarks			
Budget and revenue management			
1. Strengthening of budget transparency with the monthly publication of the TOFE on the Ministry of Finance website with a maximum lag of two months	Continuous	Fiscal transparency	Met (for the period since 5th review).
2. Adoption by the Cabinet of a customs code consistent with the COMESA zone code	March 2011	Regional trade integration	Not met. The bill was adopted in June 2011
3. Recruitment of qualified staff in the Budget Department for the preparation of the MTBF	June 2011	PFM-Budget Process	Met. One jurist and three economists were recruited in June 2011 and started work in July 2011.
4. Sign cross-debt agreements with EDD, ONEAD, Djibouti Telecom	September 2011	Financial management	Not met. Finalized with EDD and Djibouti Telecom in September, and with ONEAD in November.
5. Acquisition of the software for the introduction of the new budget classification	December 2011	PFM-Budget Process	Not met. The authorities have started consultations with countries in North Africa for the acquisition of the software.
6. Inclusion in the 2012 budget of the lowering of the VAT basis from 80 to 50 million FD	December 2011	Strengthening of tax revenue	Met. The lowering of the VAT basis was included in the 2012 budget.
7. Increase of human resources in the unit in charge of VAT	December 2011	Strengthening of tax revenue	Met. The required staff were recruited in June 2011.
8. Set up the customs revenue management software ASYCUDA for all external trade transactions in Djibouti	December 2011	Strengthening of tax revenue	Met. The software has been installed for all external trade transactions.
9. Prepare a list of enterprises whose tax exempt status has been revoked for failure to file tax returns	March 2012	Strengthening of tax revenue	Not met.
10. Prepare a report estimating fiscal expenditures due to exemptions	June 2012	Strengthening of tax revenue	Removed.
Strengthening of supervision and regulation			
11. Creation of a unit dedicated to supervision, including AML/CFT supervision	June 2011	Strengthening bank supervision and AML/CFT	Met. The unit was created in May 2011 as part of the reorganization of the CBD.
12. Recruitment of two staff for the unit dedicated to supervision	June 2011	Strengthening bank supervision and AML/CFT	Met. The two staff were recruited in May 2011 and three other staff have been redeployed to the unit.
13. Develop a roadmap with a precise timetable for the application of the banking laws	September 2011	Strengthening bank supervision	Met.
Strengthening of the Safeguard framework			
14. Adoption of an official timetable for biannual meetings of the Board of Directors and extension of its rights to oversee internal control	June 2011	Strengthening central bank governance	Not met. The timetable was approved with a delay in September 2011.
15. Publication of the full set of 2010 audited financial statements of the CBD on the CBD website, including the audit opinion and disclosure notes (changed from "Approval of audit reports and publishing the audit opinion on the CBD website six months after the end of the fiscal year")	December 2011	Strengthening central bank governance	Not met. The remaining elements of the set of 2010 audited financial statements have been published in April 2012.

TECHNICAL MEMORANDUM OF UNDERSTANDING

I. INTRODUCTION

1. This memorandum defines: (a) the quantitative performance criteria, adjustors, and structural benchmarks for the program supported by the Extended Credit Facility (ECF), which are shown in the Letter of Intent and the related tables; and (b) the scope and frequency of data to be provided for program monitoring purposes.

II. QUANTITATIVE INDICATORS

A. Definitions and Concepts

2. **Test dates**. Quantitative performance criteria are set for June 30, 2011 and December 31, 2011, and must be met at the end of each period, unless otherwise specified.

3. **Government**. For the purposes of the program, "government" is defined as the central government, excluding the social security system.

B. Quantitative Performance Criteria and Indicative Targets

Quantitative Performance Criterion 1: Continuous ceiling on accumulation of new domestic arrears

4. Definition: *New domestic arrears* are defined as payments which are authorized (*ordonnancé*) and are past due date on the wage bill and to private suppliers, public enterprises, and pension funds, incurred as of January 1 of the year and up to the end of the complementary period. The wage bill includes all gross salaries, wages, allowances, benefits, and payments, including housing assistance, that the government agrees to pay to civil servants, to military and security personnel (whether permanent or temporary), and to all other government employees, regardless of the means of payment used (cash, check, or other instrument) or the payment agent (the Treasury or another agency acting on behalf of the government). The ceiling on domestic arrears applies to the total unpaid amount subject to the technical lag (reported in the TOFE as "new arrears"), which must not exceed the sum of one month's wages or three months' pension fund contributions. The ceiling, set for each quarter in Table 1, should be respected on a continuous basis and will be monitored on a monthly basis.

Quantitative Performance Criterion 2: Continuous ceiling on accumulation of new external arrears

5. Definition: *External arrears* are defined as overdue payments (principal and interest) on external debt contracted or guaranteed by the central government or the Central Bank of Djibouti (CBD), excluding debt subject to rescheduling or cancellation. Technical arrears

(as defined in the loan contract) are not considered external arrears for program monitoring purposes. The ceiling should be respected on a continuous basis.

Quantitative Performance Criterion 3: Ceiling on net banking system credit to the government

6. Definition: *Net banking system credit to the government* is defined as the sum of net bank financing, namely, claims on the government minus government deposits with the financial system.

Quantitative Performance Criterion 4: Floor government budget balance on the commitment-basis (*ordonnancement*)

7. Definition: *The government budget balance on a commitment-basis* is defined as the overall balance (on a commitment basis, including grants) shown in the fiscal reporting table (TOFE), representing the difference between total revenue (including grants) and total expenditure, including extra-budgetary expenditure.

Quantitative Performance Criterion 5: Continuous ceiling on contracting or guaranteeing new medium- and long-term nonconcessional external debt by the government, the CBD, and public enterprises

8. Definition: Medium- and long-term nonconcessional external debt contracted or guaranteed by the government, the CBD, and public enterprises, is defined as foreign debt defined by the residency of the creditor, maturing in at least one year, contracted or guaranteed by the government, the CBD, and public enterprises, with a grant component (Net Present Value, NPV, compared with the nominal value) of at least 35 percent, based on the currency- and maturity-specific discount rates announced by the OECD (benchmark commercial interest reference rates - CIRR). The ten-year CIRR is applied to debt maturing in at least 15 years; the six-month CIRR is applied to debt maturing in less than 15 years. For program purposes, the definition of debt is set out in Executive board No. 6230-(79/140), as amended by Decision No. 14416(09/91), including commitments contracted or guaranteed for which value has not been received. The ceiling should be respected on a continuous basis.

Quantitative Performance Criterion 6: Continuous floor on currency board coverage

9. Definition: *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 gross foreign assets of the CBD represent the value of the external assets of the CBD, consisting of: (a) monetary gold; (b) SDR holdings; (c) the IMF reserve position; (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 not limited to assets used as collateral or guarantees for foreign liabilities of third parties (assets not immediately available). The floor should be respected on a continuous basis.

Indicative Target 1: Floor on social spending

10. Definition: *Social spending* is defined as subsidies and transfers to public entities, including health organizations, sports clubs, non-profit entities; and transfers to households in the form of scholarships.

III. Program Adjustors

11. The quantitative performance criteria can be adjusted as follows:

Adjustor 1: French, U.S. and Japanese payments related to the use of military bases

12. Definition: *The ceiling net banking system credit to the government* will be lowered (raised) by the amount of any excess (shortfall) compared with the projected French, U.S. and Japanese payments for 2011, related to the use of military bases (as reported in Table 1 of LOI). *The floor on the government budget balance on a commitment-basis* will be lowered (raised) by the amount of any shortfall (excess) compared with the expected French, U.S. and Japanese payments for 2011, related to the use of military bases (as reported in Table 1 of LOI).

Adjustor 2: Foreign budgetary grants and loans

13. Definition: *The ceiling on net banking system credit to the government* will be lowered (raised) by one-half of any excess (shortfall) in the total amount of the foreign budgetary grants and loans actually disbursed, compared with the program projections (as reported in Table 1 of LOI). *The floor on the government budget balance on a commitment basis* will be lowered (raised) by one-half of any shortfall (excess) in the total amount of the foreign budgetary grants actually disbursed, compared with the program projections (as reported in Table 1 of LOI).

Adjustor 3: Foreign project loans

14. Definition: *The floor on government budget balance on a commitment basis* will be lowered (raised) by any excess (shortfall) in the total amount of the foreign project loans actually disbursed, compared with the pertinent program projections (as reported in Table 1 of LOI).

Domestic arrears

15. Domestic arrears, which were audited by the company Actuaria in 2003, were reconciled again at end-2001, through negotiations with EDD, ONEAD, and Djibouti Telecom. The total of domestic arrears equals to DF 9.898.428.197 and will be reimbursed between 2012 and 2016 according to the scheduling payment below.

in Djibouti Franc	2012	2013	2014	2015	2016
Amount of arrears to repay per year	1,700,000,000	2,200,000,000	2,200,000,000	2,200,000,000	1,598,428,197

IV. Reporting Obligations

16. The authorities will provide the IMF with all data necessary for monitoring economic developments and the results of the program, including but not limited to the specific information below. Any revision of data reported previously will be quickly forwarded to the staff with appropriate explanations.

Real, monetary, and financial sectors:

17. 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).

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

Fiscal sector, including social spending:

19.

- The monthly 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;

- The extra-budgetary expenditure recorded at least quarterly in the TOFE;

- Execution of FSN expenditure, on, at least, a quarterly basis, shown as a separate line in TOFE;

- Repayment of the domestic arrears accumulated in 2009, on at least quarterly basis, shown as a separate line in TOFE;

- Committed expenditure for which payment authorizations (*ordonnancement*) have not been issued (on a quarterly basis).

- Total payments to the public utilities for services executed in the current year, both in DF and as a percentage of the total budgeted for the year, on a quarterly basis.

These data will be provided within 30 days of each month-end.

Arrears:

20. Data on domestic arrears (*ordonnancement* basis) related to: (1) the current year (monthly flows of new accumulations of arrears in all categories); 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.

21. External arrears data related to: (1) the current year, and (2) the stock at the end of the pr*evious year; c*onsolidated data for (1) and (2) will be reported monthly, within no more than four weeks.

External sector, external assistance and debt:

22. The quarterly balance of payments statistics, end of each quarter with a two quarter lag.

23. The 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.

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

25. The 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.

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