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To the Development Partners of Rwanda:

Further to the documentation of the sixth review under the PRGF arrangement and the request for a new PRGF arrangement of May 2006, this letter provides an update on the IMF's relations with Rwanda.

Rwanda's reform and stabilization efforts since 1994 have been supported by the Fund through financial and technical assistance. This includes support under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement during 2002-06 and a new three-year PRGF arrangement, which was approved by the Executive Board in June 2006. Rwanda reached the completion point under the enhanced HIPC Initiative in April 2005 and received US\$76 million in debt relief under the MDRI from the Fund in early January 2006. A recent mission concluded *ad referendum* discussions on the first review under the current PRGF arrangement and the 2006 Article IV consultation, with a possible Board date in January 2007.

Policy implementation under the PRGF has been broadly satisfactory. The attached statement, which was delivered at a donor conference in Kigali in November 2006, provides a brief summary of economic developments in 2006 as well as the authorities' medium-term agenda and their macroeconomic and structural program for 2007.

/s/

Abdoulaye Bio-Tchané
Director
African Department

Attachment

RWANDA

Statement of the IMF Staff Representative

Kigali, November 22-23, 2006

It is my pleasure to represent the International Monetary Fund at this donor meeting. Rwanda can look back to a good year. As a result of its satisfactory track record of policy implementation, Rwanda is now also benefiting from the Multilateral Debt Relief Initiative in addition to debt relief under the Enhanced HIPC Initiative. As regards Rwanda's relationship with the Fund, in mid-2006, the last review under the 2002-06 Poverty Reduction and Growth Facility (PRGF) arrangement was completed and a new PRGF arrangement approved.

Rwanda now has a window of opportunity to advance its development agenda and tackle its medium-term challenges. We thus welcome this meeting to take stock of our joint efforts and to discuss the way forward.

Medium-term challenges

Let me start out by looking at Rwanda's medium-term challenges. Rwanda has made great strides since the 1994 genocide. However, poverty remains pervasive, growth is insufficient to substantially raise living standards, and only few of the Millennium Development Goals (MDGs) have been achieved. So, what needs to be done to bring people out of poverty, raise economic growth, and advance toward the MDGs?

- **First and foremost, Rwanda has to create an enabling environment for a vibrant private sector.** It is, therefore, paramount to improve the business climate and enhance Rwanda's competitiveness. This will require a stronger legal framework, a more developed financial sector, and also large investments in human and physical capital. At the same time, there is a need to raise agricultural yields to make the economy more resilient to exogenous shocks and break the vicious cycle of poverty, with food security freeing people to seek better education and also employment in other sectors.
- **Second, Rwanda's development efforts will have to be financed without jeopardizing debt sustainability.** Despite the debt relief initiatives, Rwanda's small export base limits its capacity to carry external debt. Thus, maintaining debt sustainability will require high and sustained levels of grants for the foreseeable future. The authorities will also have to mobilize domestic revenue to contribute to the effort and, eventually, make Rwanda independent of donor funding.
- **Third, aid flows have to be used productively while preserving macroeconomic stability.** To this end, the authorities should prioritize developments needs clearly,

while managing the likely pressures for a real exchange rate appreciation from possibly large inflows of external aid by allowing more flexibility in the exchange rate. In parallel, expenditure management has to be further strengthened to assure development partners that resources are leveraged to their most productive use and public service delivery improved to ensure successful program implementation.

- **Finally, lasting peace and improved security in the region will be essential for attaining Rwanda's development goals.**

Let me now turn to policies under the PRGF arrangement, which are designed to advance in Rwanda's medium-term agenda. Let us first look back to what has happened this year.

Developments and performance under the program in 2006

In terms of macroeconomic performance, it should be noted that, despite a weak harvest, real economic growth is likely to reach more than 4 percent, driven by the services and manufacturing sectors. However, inflation has been on the rise (at 9.3 percent in September), reflecting an increase in food and energy prices, but also in the general price level.

Macroeconomic policy implementation in 2006 has been satisfactory, as evidenced by all end-June 2006 quantitative performance criteria having been met. There are also indications that the program has remained broadly on track through September.

- Fiscal policy was tighter than planned by about $\frac{3}{4}$ percent of GDP in the first half of 2006, mostly because revenue overperformed. The strong revenue performance continued through September, so that, despite some unforeseen outlays, the September targets for the domestic deficit, net credit to government and arrears clearance were also met.
- Reserve money stayed within the program limits at end-June and end-September 2006. However, management of monetary policy was complicated by a large increase in private sector credit, which was partly driven by commercial banks' aggressive lending practices.

Progress has been made on the structural front:

- **Public expenditure management.** After disappointing adherence to structural conditionality in expenditure management in 2005, reforms in public expenditure management have gained some momentum with the passage of the Organic Budget Law in August 2006. Guidelines have been issued on doing bank reconciliation (end-October 2006 benchmark) and the authorities have outlined their reforms over the next two years in a detailed action matrix. A report has been issued on the monitoring of project accounts showing inflows and outflows during the first half of 2006. However, the authorities have not yet established rolling spending plans for these

accounts until mid-2007 and the related end-August 2006 performance criterion on the monitoring of project accounts was not met.

- **External debt management.** Debt payments to BADEA have been confirmed, providing assurances that there be no recurrence of external arrears. Moreover, the external debt data bases maintained by the Ministry of Finance and the National Bank of Rwanda have been reconciled (end-September 2006 benchmark).
- **Financial sector reform.** Based on the World Bank and Fund's Financial System Stability Assessment, the central bank has moved forcefully to strengthen banking supervision. In particular, amendments to the banking law were submitted to parliament in September to bring the legal framework for banking supervision in line with international practices (end-September 2006 benchmark). A meeting to determine in coordination with donors the medium-term financial sector reform plan is expected to take place in January 2007.
- **Business environment.** Acknowledging that Rwanda suffers from high cost of doing business particularly in the area of property rights, the authorities have submitted to cabinet in October 2006 draft laws on establishing a commercial registration agency and on protecting intellectual property (end-October 2006 benchmark).
- **Governance.** As a long-term solution to the management of Prime Holdings' two hotels, a lease contract has been signed with an international hotel chain.
- **Export promotion.** Various initiatives for sectoral export promotion are under way. With respect to traditional export sectors, Rwanda has been able to move into high-value niche coffee markets and three tea estates were privatized in 2006. Progress has also been made in the tourism sector and exports of handicraft.

The agenda for 2007

As you know, a recent mission discussed with the authorities a program for 2007 in the context of the first review under the PRGF arrangement.

The proposed 2007 program seeks to maintain macroeconomic stability while setting the stage for stronger medium-term growth. It is based on a real growth rate of 4½ - 6½ percent, inflation returning to 5 percent, and a level of international reserves of more than four months of imports. With a further scaling up of aid expected for 2008, the program allows a one-off moderate draw down of reserves in 2007 to finance an increase in the deficit (excluding spending on peacekeeping and demobilization) by one percent of GDP.

With the design of the macroeconomic program taking into account a possible scaling up of aid, it will be important to gear policies to managing a possible appreciation of the real exchange rate from higher donor flows. Accordingly, the 2007 program allows a further widening of the fiscal deficit as long as it is financed by grants and macroeconomic

stability is maintained. To this end, the central bank has reaffirmed its commitment to step up the sale of foreign exchange and allow an appreciation of the exchange rate to avoid a rekindling of inflation and a crowding out of the private sector. Higher grants would enable the government to substantially increase priority spending to make progress toward the MDGs and enhance the productivity of the economy, including by increasing funds for education and health and investments in the water and energy sectors.

Structural policies aim at managing the development process and improving conditions for the private sector. With respect to the former, the focus under the Fund's PRGF is on continuing reforms in public expenditure management, debt management and the civil service. Moreover, the program limits the contracting of external debt (including concessional debt) to prevent a renewed debt built-up. To promote private sector activity, the authorities are working together with the World Bank and other donors, who take the lead in this area, to remove obstacles to growth, improve Rwanda's competitiveness, and reduce the costs of doing business. In the context of private sector development, the PRGF places particular emphasis on financial sector and legal reforms, as well as on the agricultural sector.

Conclusion

It is clear that Rwanda has come a long way. Nonetheless, formidable medium-term challenges remain. We stand ready to work with the authorities and donors to design and implement a program to increase growth, reduce poverty, and advance toward the MDGs. We encourage the authorities to further strengthen their dialogue with donors and look forward to working together with you to create a brighter future for Rwanda's children.