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

January 25, 2012

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LETTER OF INTENT
AND MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

Djibouti, January 25, 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 in the context of the Extended Credit Facility (ECF) arrangement. It also sets out the government's intentions in the area of economic policy and the reforms envisaged for 2012.
2. The objectives of the ECF-supported program approved in 2008 remain unchanged. These objectives are consistent with our determination to make Djibouti a hub of trade, financial services, and logistics and related services. The ECF-supported program will remain aligned with the National Social Development Initiative (INDS), which is a reflection of our national economic development and poverty reduction strategy.
3. Program implementation suffered significant disruption starting in the second quarter of 2011 owing to the exceptional drought conditions. More than 12 million people (11 percent of the population) in the Horn of Africa have been affected by one of the worst droughts in 60 years, resulting in the loss of harvests and cattle. Djibouti is one of the most affected countries, along with Ethiopia, Kenya, and Somalia. The current drought, the fourth consecutive year without rainfall, has severely affected some 120,000 people in rural areas, that is, 50 percent of the rural population, and 15 percent of the total population, and around 20,000 refugees, while herds have been drastically reduced. Further, the drought has exacerbated a structurally critical food security situation, with 14.5 percent of the urban population (Djibouti city and the five regional capitals) living in food insecurity, and with more than 12,000 children under five years old suffering from malnutrition across the country, according to the most recent national nutrition survey of March 2011. Based on available data, around 33 percent of Djiboutians live in high-risk areas, and 35.3 percent of the economy is vulnerable to natural risks.
4. Against this backdrop, we launched an appeal for emergency aid to our partners. In response to the appeal, various partners have committed to providing us with aid amounting to a total of US\$ 47 million, based on confirmed amounts at end-October 2011. We have therefore 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. In line with these commitments, since July 2011 there have already been partial payments made and the remainder is expected to be received over the next two years, with the highest concentration of disbursements in 2012. Most of this aid is expected to take the form of in-kind donations channeled mainly through the World Food Program.

5. The adverse effects of the drought occur in addition to the strong surge in international prices of petroleum products and, more particularly, foodstuffs, from which the population was already reeling. To meet the additional balance-of-payments financing needs in 2011–12 resulting from the drought and the hike in import prices, we are seeking an augmentation of access to ECF resources of 60 percent of quota (SDR 9.54 million), to be disbursed in two tranches upon approval of the fifth and sixth reviews.

6. The program remains on track, despite temporary deviations from the end-June 2011 targets (Table 1). Notwithstanding strict expenditure control in the first half of 2011, fiscal performance suffered from weak collection of tax and nontax revenues. Collection of direct and indirect taxes slowed due to the election period, the installation of the new government and the reorganization of the revenue administration, but also because of the indirect impact of the drought on households, through transfers to family members often residing in neighboring countries, notably Somalia, and the contribution of private operators to solidarity efforts. In addition, owing to the steep spike in international prices, we incurred losses on diesel excises so as to offset the impact of higher oil prices on the most vulnerable segments of the population.

7. This mixed performance resulted in the nonobservance of the performance criteria on the fiscal balance and on net banking system credit to the government. Furthermore, as a result of the tight cash flow situation, the continuous performance criterion on the non-accumulation of external arrears was not observed in the second semester and the continuous performance criterion on the accumulation of new domestic arrears (related to delays in the payment of salaries and pensions) was not observed in the third quarter. The other performance criteria and quantitative indicative targets for end-June 2011 were observed with the exception of social spending, which was slightly below the target. Further, we did not contract any non-concessional debt either in 2010 or over the course of 2011.

8. Most of the structural benchmarks for 2011 have now been met (Table 2), with the exception of: (i) regular production and publication of the TOFE on the website of the Ministry of Finance (*continuous structural benchmark*) up to August 2011, because of repeated delays in the preparation of the fiscal data; (ii) adoption by Cabinet of a new customs code by end-March 2011 (*structural benchmark for end-March 2011*), which was completed in June; (iii) adoption of an official timetable of quarterly meetings by the Board of Directors of the Central Bank of Djibouti (CBD) (*structural benchmark for end-June 2011*), which was completed in September; (iv) the conclusion of cross debt agreements,

which were finalized in September with the national electricity company (EDD) and Djibouti Telecom, and in November with the national water and sanitation office (ONEAD); (v) the acquisition of software to introduce the budget classification (*structural benchmark for end-December 2011*), for which however financing has been committed by the African Development Bank; and (vi) the publication of the 2010 audited financial statements of the CBD, including the audit opinion and the disclosure notes (*structural benchmark for end-December 2011*; while the 2010 accounts have been posted on the CBD website, the full audit report will be posted soon).

9. To achieve the objectives of the ECF arrangement, our program for 2011 remains focused on: (i) the pursuit of prudent, coherent fiscal policy, 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 AND OUTLOOK IN 2011 AND 2012

10. Djibouti's economy is expected to have grown by 4.4 percent in 2011, compared to 3.5 percent the year before, boosted by the resumption of transshipment activity, the stabilization of the situation in Ethiopia and deepening of the services sector, particularly banking and telecommunications (mobile telephony and Internet). In 2011, inflation is estimated to have risen to 5.3 percent, pushed up by the substantial rise in world food and fuel prices. Competitiveness, measured by the effective exchange rate, worsened from 2008 to 2010 as a result of the appreciation of the Djibouti franc against the euro, but the trend was reversed in 2011 because of the positive differential between domestic inflation and inflation rates in Djibouti's main trading partner, Ethiopia.

11. According to our estimations, the current account deficit should have reached 11.7 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 food and fuel prices on the world market. International reserves stood at US\$231 million at end-2010, but have recently been under strain from higher imports, weak fiscal performance, and a less vigorous than expected resumption of FDI. Reserves are estimated to have remained broadly stable at end-2011, guaranteeing adequate currency board and import coverage. The stock of external debt continued to decline, from 56 percent of GDP at end-2010 to an estimated 55 percent at end-2011.

12. Growth is expected to rise to 4.7 percent in 2012, owing mainly to the speeding up of activity at the port and in the services sector. However, as in 2011, FDI will remain subdued reflecting the dampening effect of the global economic and financial crisis. Inflation should stabilize at 5 percent in line with the world food price cycle, which we foresee will finally begin to weaken. The current account deficit is set to stabilize at a high level of 11.8 percent of GDP. Despite the modest upturn in exports of goods and services, imports will continue

the upward trend we saw in 2011 as a result of the knock-on effects of the drought and the rise in FDI flows.

II. GOVERNMENT FINANCE

A. Fiscal policy

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

Fiscal policy in 2011

14. In light of spending pressures, we have revised our fiscal balance target for 2011 and expect to close with a deficit of 0.4 percent of GDP for the year. This target should allow catching up with the delays in domestic arrears payments that had already been programmed for 2010. We also focused on making up for the delays in direct and indirect tax revenue collection in the last quarter of 2011 by taking several urgent measures described below. In respect of expenditure, we maintained the freeze on public hiring and wages. New public-sector employment programs will be handled through staff redeployment. Expenditure on goods and services included the settlement, already executed, of domestic arrears accumulated to EDD and ONEAD in 2009. Social and capital expenditure was planned to increase in line with the poverty reduction targets within the INDS framework. However, achieving the deficit target of 0.4 percent of GDP required deferring capital expenditure of an amount equal to around 1 percent of GDP. In 2011, we have not engaged in any extrabudgetary spending, and we commit to not engaging in any such spending in the future.

15. Financing will be provided mainly from external resources, and this will enable the authorities to replenish their deposits with the domestic banking system, in particular the CBD, which dropped significantly in early 2011.

Subsidy policy

16. We relied on a fuel and food price subsidy policy to mitigate the effects of the rise in commodity prices on the most vulnerable population groups. In the energy sector, starting in January 2011, we stabilized the price of diesel by reducing excises, translating into forgone tax revenues of around DF 2,800 million vis-a-vis the budget law. Mindful that, given its budgetary constraints, the government cannot afford to continue absorbing a loss of this magnitude, we plan to undertake a study (with the assistance of the IMF) on the introduction of social protection for vulnerable sectors (such as public transportation, taxis, and bakeries), while gradually increasing the diesel price at the pump in line with the targeted level of tax revenues included in the price structure of each product. With that in mind, we have already increased the diesel price at the pump by DF 3 in October and by an additional total of DF 8

in November and December (*prior action*) despite a fall in FOB prices. In the event that the social constraints facing the country make it impossible to increase the price of diesel sufficiently to meet the target for petroleum tax revenues of DF 800 million in 2012, we undertake to delay domestically-financed investments for an amount equivalent to the shortfall. We have also fixed the price of kerosene at an affordable level for the most vulnerable segments of the population through a subsidy of around DF 60 million for 2011.

17. Cereal production (of around 8,000 metric tons in 2010 and 9,000 metric tons in 2011) grown in Ethiopia and Sudan and managed by the Djiboutian food security company, is sold on the local market at subsidized prices, with a view to stabilizing local food prices, at a budgetary cost of around DF 103 million. In the interest of increased transparency of the subsidies, we plan to prepare a summary balance sheet of the food security program for FY 2010 by end 2011. We will also regularly disclose the operating accounts of the food security company.

2012 Budget law

18. In December, Cabinet has approved the 2012 budget law in accordance with the conclusions of our discussions. The main thrusts of the budget law remain consistent with the objectives of the INDS, especially the continuation of the programs undertaken in the context of the Millennium Development Goals despite a more somber international environment. With regard to revenues, we intend to maintain the tax revenue to GDP ratio constant at the 2011 level, thanks to reforms of the VAT and exemptions as well as to our tax collection efforts. On the expenditure side, we will seek to raise our capital expenditure in sectors with growth potential, while pursuing the fiscal restraint imposed by the constraints on the revenue side. In that context, we will maintain the hiring freeze in the public service, with the exception of the social sectors, i.e., education and health. We are also committed to maintaining the freeze of wages in the public sector, but we plan to increase the lowest level of the public sector salary scale to fight poverty by catching up with the cumulated loss of purchasing power of the lowest paid public sector employees.

19. One of the major challenges facing us 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, on taking office the new government reorganized the institutional framework, specifically by bringing vocational training under the umbrella of the National Education Ministry. We have also opened a logistics training center to promote training in the skills needed in high-technology sectors like the port, transport, and energy. To facilitate the employment of young graduates outside the civil service, we have established a youth employment promotion fund and, through the national budget, we are financing a loan initiative for business creation. Already seven start-up projects have been approved and have effectively begun doing business. Further, we have put in place a guarantee fund for loans granted within that framework.

B. Fiscal Reforms

20. In 2011 and 2012, we intend to push forward with fiscal reform measures with the objective of building capacity for tax collection, particularly in view of the gaps recorded in the first two quarters, expenditure control, and fiscal planning and management. Indeed, to deal urgently with the issue of weak fiscal revenues, we have decided to implement the following urgent measures: (i) strengthening of controls by the revenue collection agencies, particularly off-site inspections (for customs and taxes) and sampling, which we plan to continue in 2012, particularly with regard to imports subject to tax exemptions (investment code); (ii) publication of the list of property owners in default of property taxes with, in the case of persistent nonpayment, the possibility of seizure and sale of the property; (iii) issuance of reminders to and application of enforcement measures against companies in payment default; (iv) issuance of regular reminders to taxpayers, seizure of accounts in persistent default; (v) stepped-up tax audits of companies operating locally, particularly, those that obtained contracts in the context of tax-exempt projects or with foreign military bases; and (vi) recovery of tax claims outstanding from previous years as well as amounts due for the current year from public entities. Lastly, for FY 2012, a commission has been established to initiate and recommend new tax measures to strengthen the level of fiscal revenues and simplify the business environment (facilitation of procedures for setting up a business and simplifying the process of formalization of informal activities).

Direct and indirect taxes

21. In the context of the existing program commitments, in June we adopted the customs code, which was modernized to make it consistent with that of the Common Market for Eastern and Southern Africa (COMESA) (*structural benchmark for end-March 2011*). We have included in the 2012 budget the lowering of the VAT threshold from DF 80 million to DF 50 million (*structural benchmark for end-December 2011*), for which an awareness-building campaign for operators has been launched, and we have already strengthened the VAT unit with competent human resources (*structural benchmark for end-December 2011*). We have introduced the ASYCUDA software for managing customs revenue on all external trade transactions (*structural benchmark for end-December 2011*). We also intend to (i) strengthen coordination between the entities responsible for managing the VAT and direct taxes, based on the extension, already in effect, of the single taxpayer identification number (NIF) to enterprises subject to the declaration of direct taxes and to other taxpayers; and (ii) strengthen the functionality of the tax center opened in 2011 in the commune of Balbala consistent with the proximity policy of equipping each major region of the country with similar centers (the two regional treasuries of Ali Sabieh and Tadjourah will soon be operational) in the context of decentralization. The ASYCUDA system will incorporate the NIF through an interface with the tax directorate, thus improving taxpayer identification.

22. In respect of exemptions, we intend to: (i) resume the work of the commission, including the tax and customs services and the National Investment Promotion Agency

(ANPI), tasked with reviewing the conditions for the granting of exemptions for new investments, without, however, modifying the incentives already granted, and producing a list of beneficiaries; (ii) introduce a requirement for all enterprises granted exemptions to file tax returns or face nonrenewal of their exemptions in case of noncompliance (an information campaign has been launched in the press intended for the enterprises concerned), assign the required personnel to estimate the tax expenditure of the government, and draft a report on tax expenditure, which will be annexed to the 2012 supplementary budget. We intend to publish the list of enterprises whose tax-exempt status has been revoked for failure to file their tax returns (*structural benchmark for end-March 2012*); and (iii) not renew the exemptions of enterprises that fail to comply with the provisions of the code.

Expenditure control and public financial management

23. Given the fiscal slippages at end-2009, we have strengthened expenditure control and public financial management. On the expenditure control side, we have (i) in 2010, improved coordination among the principal structures of the Ministry of Finance by creating a sub-directorate responsible for auditing and monitoring the accounts of public institutions within the Treasury Directorate and a central accounting agency for hospital facilities, and we also enhanced the status of government accounting staff at public institutions; (ii) implemented preventive expenditure control measures such as sustained surprise audits at five ministries in 2011 to update and monitor the single register of civil servants and the physical inventory of government assets. As regards financial management and transparency, we (i) prepared, on a commitment basis, bi-monthly cash programming exercises, expanded to include the Ministries of Education and Health, except for a brief period during the summer; (ii) recently restructured the Treasury Directorate by creating a separate government accounting directorate to improve transparency in the execution of treasury operations; (iii) replaced most of the government accounting staff in the ministries and public enterprises to ensure greater transparency and rigor in the management of public assets; and (iv) annexed the budgets of the Water Fund and Youth Fund to the 2011 budget law.

24. In 2011 and 2012, we plan to continue these efforts by pursuing: (i) a policy of transferring the balances of government accounts and of donor-financed project accounts to the single treasury account; (ii) the preparations for the establishment of a medium-term budget framework (MTBF) for the 2013 budget law by recruiting qualified staff for the Budget Directorate (*structural benchmark for end-June 2011*) and amending, if necessary, the organic and budget laws for the 2013 budget, with support from our partners, in particular the IMF and UNDP; (iii) 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, to be introduced in the context of the 2013 budget, with the help of adequate software, for which financing has been committed by the African Development Bank and which we expect to acquire by June 2012 (*structural benchmark for end-December 2011*).

Arrears and cross debt

25. We remain determined to reduce the stock of domestic arrears, including those accumulated in 1995–2001, with possible assistance from donors, and to prevent further accumulation. We undertake to: (i) strengthen controls on the public expenditure chain so as not to accumulate further arrears, with the exception of arrears attributable to the one-month lag in the payment of civil servants' wages and the three-month lag in pension fund contributions, which we intend to reduce as resource availability allows; (ii) monitor, on a regular basis, the situation regarding domestic arrears and execution of payments to public utilities (which will be reported to IMF staff on a quarterly basis) in the context of the bi-monthly cash programming exercises; and (iii) continue to exercise prudence in our budget appropriations for current expenditure and social spending, and in external financing for which agreements have not yet been signed.

26. In November 2011, slightly behind the initially programmed schedule, we prepared a summary table on the situation of cross debts among public enterprises and pursued the attendant debt consolidation process with the public enterprises concerned by signing all of the relevant agreements (*structural benchmark for end-September 2011*). We intend to repay over the 2011–2012 period the outstanding payments arrears accumulated in the course of 2009, by drawing on specific budget line items under expenditure on goods and services.

III. EXTERNAL DEBT

27. Progress in relations with the Paris Club creditors 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 on comparability of treatment under the Paris Club agreement, we have signed bilateral agreements with Saudi Arabia and have contacted the United Arab Emirates and Kuwait to begin negotiations with a view to obtaining treatment comparable to the Paris Club agreement.

28. However, given the strained cash-flow situation in the first half of the year, other external arrears have been accumulated since May 2011, by the government and some public enterprises (EDD and Société Immobilière) vis-à-vis multilateral and bilateral creditors, including Paris Club creditors. These arrears were settled in the course of October, November, and December 2011. We undertake to avoid any future accumulation of external arrears, including those arising from public enterprises, and, to that effect, we intend to strengthen 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.

29. To preserve debt sustainability, we will continue to contract only concessional loans and prioritize projects to be funded under the INDS. Consequently, under the auspices of the Ministry of Finance, we also plan to improve coordination among the various ministerial departments in the context of the government's financing programs as well as the related

policies and actions. We also plan to extend to public enterprises the requirement to refrain from contracting nonconcessional debt, while retaining the option to exclude those enterprises whose operations are managed on a purely commercial basis.

IV. MONETARY AND FINANCIAL POLICIES

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

31. Growth of credit and deposits has been high in recent years, fuelled by the arrival of new banks and a sustained demand for credit to the private sector. However, the trend was reversed in the first quarter of 2011 as a result of a reduction in current account overdrafts, which account for 57 percent of loans to the private sector. The reversal derived in part from uncertainty owing to the election period, and from the situation of one bank which was in the process of changing ownership. While credit to the private sector recovered in the second quarter of 2011, deposits continued their decline. Despite strong growth in the banking sector over the past few years, the financial sector remains healthy, with a relatively low level of nonperforming loans and disputed loans, most of which are historical loans. The banking sector has seen a marked expansion in financial products and internet banking activity.

A. Banking Supervision

32. Mindful that banking system growth increases the pressure on bank supervision and regulation, we are implementing our reform program in accordance with the broad guidelines of the Financial System Assessment Program. We have started strengthening supervision by reorganizing the supervisory structure and setting up a dedicated supervision unit, as recommended by the technical assistance missions of the IMF's Monetary and Capital Markets Department and the Banque de France (*structural benchmark for end-June 2011*). We have also recruited two officers (*structural benchmark for end-June 2011*), in addition to the senior official already hired for the unit, and have begun training staff in the core skills for effective off-site and on-site supervision. We also conducted the on-site inspection of five banks and one microfinance institution in 2011 and plan to inspect another bank before the end of the year, and to pursue continuous off-site supervision of banks. We are currently in the process of revising the charter of foreign exchange bureaus to make it compliant with the new banking law.

33. To address the challenges posed by the implementation of various banking sector laws approved in the first half of 2011, we have developed a road map with a precise timetable for bringing these laws into effect (*structural benchmark for end-September 2011*).

In this regard, preparation of the enabling texts of the banking law and supervision instruments has been completed and the new instructions were adopted in December 2011.

34. As regards strengthening the banking system regulations, the National Assembly adopted the laws on Islamic finance and financial cooperatives in January 2011. Further, all banks now submit monthly financial statements, allowing for the identification of risks such as those related to credit, liquidity, and exchange operations, as well as their internal audit reports. These data provided regularly by the banks will enable us to compile bi-annual financial stability indicators. We have also tightened the imposition of penalties on banks that fail to meet the requirement for regular disclosure of their financial statements. We have improved regulation of the banking system. In January 2011, the National Assembly adopted the banking law, which provides for an increase in the required minimum capital, which will be tripled to DF 1 billion over a period of up to three years. Moreover, in view of the current banking environment, we have decided to strengthen the conditions for granting new licenses through strict application of the laws recently entered into force. Further, we are preparing for the upcoming introduction of reserve requirements, which will be an important new tool for liquidity management by the CBD. Similarly, in November we introduced a foreign currency cash flow forecasting tool to facilitate efficient monitoring of changes in the Bank's foreign exchange reserves.

B. Financial Sector Development

35. 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-sized enterprises (SMEs) 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. The provisions of the banking law will be implemented with technical assistance from the IMF.

C. Governance of the CBD

36. To ensure the integrity of CBD operations, we have been implementing the recommendations of the safeguards assessment mission, and hosted another such mission during the month of November in the context of augmentation of access under the ECF. Starting with the 2011 financial year, financial reports will be completed within six months from the end of the exercise, as will the audit opinion. Additionally, the publication of the full set of financial statements for 2010 on the website of the CBD, including the audit opinion and disclosure notes, is in progress and will soon be completed (*structural benchmark for end-December 2011*). We have strengthened the internal control by updating the procedures in force. In September 2011, the Board of Directors adopted an official timetable of quarterly Board meetings pursuant to our commitments, and expanded the

prerogatives of the Board of Directors of the CBD (*structural benchmark for end-June 2011*). With regard to the latter, the Board decided to consider creating an audit committee in the near future to provide oversight, and an audit charter is under preparation.

D. Combating money laundering and financing of terrorism

37. We are currently remedying the weaknesses in the area of combating money laundering and financing of terrorism. In May 2011, the National Assembly adopted 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, submitted by the CBD in collaboration with the Ministry of Justice. The CBD is currently considering long-term technical assistance in this area, to be financed by donors.

V. COMPETITIVENESS AND STRUCTURAL REFORMS

38. As a result of the currency board arrangement, Djibouti's attractiveness for investment depends crucially on the competitiveness of the economy, which is still hampered by the high costs of the principal factors of production and weaknesses of 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.

39. We have made considerable progress on structural reforms, notably with regard to the Investment and Commercial codes and the law on industrial property. The Labor Code is now being enforced, including the collective bargaining arrangements for the various industries and enterprises. The final components of the new Commercial Code, namely the company and bankruptcy laws, were finalized at end-2010. The Commercial Code has been adopted in full by the National Assembly in October 2011.

40. We are pursuing the reforms in the energy and water sectors. Interconnection with Ethiopia's electricity grid is now completed and, on average, covers over 50 percent of current consumption in Djibouti at very favorable negotiated rates, which should enable Djibouti to reduce its energy costs. We will update the energy master plan with donors. With the support of the World Bank, a study, aimed at assessing the various options for developing thermal energy potential, was launched in November 2011. We continue to implement the recommendations validated by the final study on the restructuring and adjustment of human resources for the EDD carried out by IDEA Consulting. Lastly, in the water sector, ONEAD is considering a sizeable seawater desalination investment program to be financed by donors, with significant support from the European Union.

VI. DATA

41. The still-low quality of our statistical database continues to hamper our efforts to formulate and monitor economic policies. 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, the balance of payments, and government finance. In June 2011, the National Assembly approved the legal framework by ratifying the draft law on the organization of statistical activity and the structure of the National Statistics System. As regards the statistical base, in 2009 we completed the general population census. With support from our development partners, we expect that the survey of economic activities, of which the data are to be included in 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 as of January 2012, following the household consumption-budget survey set to begin in January 2012.

VII. PROGRAM MONITORING

42. Due to the delay in concluding program discussions, we will no longer be able to request a modification of the end-December 2011 quantitative performance criteria on the fiscal balance and net credit to the government (related to the sixth review) to reflect changes in the macroeconomic scenario. Therefore, the existing end-December performance criteria remain in place (Table 1 and Technical Memorandum of Understanding below), even though, consistently with the understanding with Fund staff, we expect that fiscal policies will be also considered in relation to the revised fiscal objective of a deficit of 0.4 percent of GDP in 2011. Some of the program reforms will be the subject of structural benchmarks (Tables 2 and 3 below). To compensate for the losses in fuel revenues, the diesel prices have been increased at the pump in October, November, and December (*prior action*). In light of the reorganization of the Ministry of Finance with an expanded scope of activities, and to ensure better coordination of the actions required for implementation of the ECF-supported program, we will establish, under the supervision of the Secretary General, a macroeconomic unit that will take on the functions of the committee responsible for monitoring the program and will be entrusted with macroeconomic analysis. The unit will be tasked with continuing the preparation of the promised documents within the agreed timeframes, monitoring of the targeted program variables, and preparing a reference macroeconomic framework for the Ministry of Finance (*prior action*). For the latter task, each directorate shall designate a contact person who will be responsible for preparing and communicating data on actual and projected revenues and expenditures.

VIII. CONCLUSION

43. In light of the overall performance of the program and based on the policies set forth in this letter, we request waivers for the nonobservance of the criteria at end-June 2011 relating to net banking system credit to the government, the fiscal balance, and the continuous criteria on the non-accumulation of new external arrears and on the accumulation of new domestic arrears. Moreover, we request a waiver for the non-observance of the continuous criterion on the non-accumulation of new external arrears resulting in a noncomplying disbursement at the time of the fourth review, caused by the misreporting on

the external arrears accumulated to the Islamic Development Bank in the second quarter. On that basis, we request the conclusion of the fifth review of the ECF arrangement, with the disbursement of an amount of SDR 1.476 million and the first tranche of the augmentation of access under the ECF, for the amount of SDR 4.77 million, the augmentation of access of SDR 9.54 million, and the rephrasing of disbursements.

44. 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/

Ilyas Moussa Dawaleh
Minister of the Economy, Finance,
Responsible for Industry and Planning

/s/

Djama M. Haïd
Governor
Central Bank of Djibouti

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

(In millions of Djibouti francs; unless otherwise indicated)

(Cumulative flows)

	2011									2012		
	Mar. 31			Jun. 30			Sept. 30		Dec. 31	Mar. 31		
	Indicative Targets			Performance Criteria			Indicative Target		PC	IT		
	Prog.	Adj. Prog.	Prel. Act.	Prog.	Adj. Prog.	Prel. Act.	Prog.	Prel. Act.	Prog.			
<i>Performance criteria</i>												
I. Ceiling on accumulation of new domestic arrears 2/ 3/	2,079		2,340	2,260		2,629	2,135	...	2,279	2,279		
II. Ceiling on accumulation of new external arrears 3/ 4/	0		0	0		176	0	430	0	0		
III. Ceiling on net credit to government from the banking system	-3,459	-2,448	-937	488	-1,817	-549	-2,015	...	-2,600	-1,845		
IV. Floor on government budget balance (ordonnancement)	1,255	944	-119	-2,628	-99	-378	-1,903	...	883	6		
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		
VI. Floor on currency board cover 3/ 5/	105		115	105		116	105	147	105	105		
<i>Indicative target</i>												
I. Floor on social spending	2,232		3,296	6,541		5,570	10,024	8,210	14,451	...		
<i>Memorandum items 1/ :</i>												
Adjuster #1	Projected French, U.S., and Japan military base payments		4,646		3,657	4,024		6,373	7,154	7,154	12,736	5,954
Adjuster #2	External budgetary grants and loans		255		210	504		416	2,548	771	3,228	868
Adjuster #3	Externally financed public investment loans (PIP)		2,111		1,411	3,228		3,004	4,466	5,043	6,815	1,384

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

1/ See the Technical Memorandum of Understanding (EBS/10/235) for definitions and adjustor calculations.

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

3/ To be implemented on a continuous basis.

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

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

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

Measures	Date	Motivation	Status
Prior actions			
1. Increase the diesel price at the pump	5 days before the Board meeting	Strengthening of tax revenue	Met. Diesel price at the pump increased by 8 DF.
2. Create a macroeconomic unit in charge of program coordination at the Ministry of Finance	5 days before the Board meeting	Strengthening of program monitoring	
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	Not met. The data for December through August 2011 were published with a delay.
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. The agreements were 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 AfDB has agreed to fund the acquisition of the software. 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 have been 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	
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 audited 2010 accounts have been published on the CBD website, but with only part of the audit report.

ATTACHMENT: 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).

IV. REPORTING OBLIGATIONS

15. 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:

16. 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).

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

Fiscal sector, including social spending:

18.

- 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:

19. 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.

20. 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.

External sector, external assistance and debt:

21. The quarterly balance of payments statistics, end of each quarter with a two quarter lag.
22. 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.
23. The monthly data on the evolution of external debt, including arrears and rescheduling operations, within six weeks of each month-end.
24. 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.
25. 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.