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DJIBOUTI

Selected Issues

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Approved by the Middle East and Central Asia Department

December 19, 2003

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OVERVIEW

1. The most important challenge facing the Djibouti authorities in the years to come is achieving high rates of economic growth in order to create employment opportunities for a rapidly increasing labor force and to alleviate rising poverty.[1] To these ends, the authorities have formulated an ambitious national poverty reduction strategy aimed at accelerating the implementation of structural reforms that would promote private sector activity and investment, while maintaining a stable macroeconomic environment and improving social services. Achieving sustainable high rates of growth in an economy with a narrow production base, high cost of production factors, a weak institutional framework, and an uncertain regional environment will not be an easy challenge to meet. However, the authorities managed to start the needed reform process. While progress was achieved in correcting large financial imbalances, significant structural rigidities remain that constrain economic growth. This selected issues paper aims to provide a review of recent developments, the results of policy reforms achieved so far, and the remaining reform agenda over the medium term in two particular areas, namely the financial system and the fiscal sector.

2. Chapter I analyzes the evolution of the financial system with a focus on ways to enhance its effectiveness. It shows that, notwithstanding past efforts to improve and develop financial services in Djibouti, financial intermediation remains limited and the depth of the financial sector needs to be increased. To that effect, the authorities need to (i) strengthen the legal framework, promote transparency, and pursue efforts to step up banking supervision; (ii) remove obstacles to the expansion of credit to the private sector, by improving the functioning of the judicial system and creating an environment conducive to private sector development; and (iii) enhance the development of small businesses, which are often excluded form bank credit, through the establishment of microcredit programs and an appropriate regulatory framework to ensure the efficiency of these programs.

3. Chapter II reviews the fiscal adjustment experience undertaken by the authorities, the cornerstone in reestablishing the macroeconomic fundamentals in Djibouti. It shows that the fiscal deficit (on a payment-order basis) was reduced from a peak of 13 percent of GDP at the start of the civil war in 1992 to 3.3 percent of GDP by 2002, a significant effort that has few parallels in recent history. Stylized facts about this fiscal adjustment indicate that it was achieved mostly through a reduction of expenditures. Looking ahead, although Djibouti has made significant strides in reforming its tax system and spending management practices, the reform agenda must be pursued in order to (i) build a modern tax system; (ii) further strengthen expenditure management; and (iii) reallocate additional resources to productive

[1] Per capita income is estimated to have declined by about 3 percent per year from 1994 to 2002. The 2002 household living standards survey (EDAM-IS2) shows that more than one-third of Djibouti households live below the extreme poverty line, spending less than two dollars per day. This survey also estimates that about 60 percent of the labor force is unemployed.

use and to social sectors. Finally, an assessment of the sustainability of the medium-term fiscal position in light of the government's spending plans to address poverty issues shows that, in order to reduce the government debt-to-GDP ratio, the authorities will need to maintain a stronger fiscal balance than in the past, implement policies to sustain higher economic growth, and continue to adopt a very prudent external borrowing stance.

CHAPTER I. THE FINANCIAL SYSTEM IN DJIBOUTI*

I. INTRODUCTION

1. **Djibouti has had a currency board arrangement (CBA) since 1949, from the time when it was still a French territory.** Being operated in a pure form, the central bank does not extend credit to the government, the banking system, or anyone else, and maintains foreign resources in excess of the value of its monetary liabilities. The CBA served well in keeping inflation at a low level and enabled Djibouti to maintain full convertibility into the U.S. dollar at a fixed exchange rate despite economic uncertainties throughout the eighties and nineties. However, Djibouti did not always implement policies and rules required for the smooth operation of the CBA. In particular, fiscal policy in the 1990s was expansionary (see Chapter II for more details), balance of payments was structurally in deficit, and the labor market was rigid. At the same time, Djibouti's external competitiveness has deteriorated substantially and unemployment has risen significantly. Despite these difficulties, the CBA was maintained, supported by the ongoing financial liberalization, the large openness of the economy, and a deeply rooted respect for the CBA within the Djibouti society and political structure.

2. **In spite of the obvious need for improved financial services in Djibouti and the efforts of the authorities to develop them, the financial system remains confined to performing a short-term financial function and has not sufficiently contributed to growth during the period from 1990 to 2002.**[2] The share of the financial sector in GDP remained at about 11 percent between 1990 and 2002,[3] while the assets of the banking system stagnated at about 11 percent of GDP. The size of the financial sector dwindled as the number of commercial banks declined from five to three, while that of insurance companies declined from eight to two. This relatively noncompetitive banking system is now dominated by foreign-owned banks. Financial intermediation is still hindered by the lack of diversification both in terms of institutions and financial products, lending practices that aim to minimize risks, and a weak legal structure for contractual and property rights. Financial reforms introduced so far, including those under two Fund-supported programs, have had only a minor contribution in alleviating the impact of these factors.

3. This chapter reviews developments and the role of the financial system during the program period and discusses ways to enhance its effectiveness. Section II will review the CBA and its role in the macroeconomic developments and Section III will discuss the financial system and assess financial intermediation. Finally, section IV will discuss the main

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* Prepared by Jemma Dridi (MCD).

[2] However, the development of a financial system is itself endogenous to growth, thus the lack of development in not necessarily a cause of low economic growth. Box I.1 provides a brief overview of the literature on the relationship between financial sector development and economic growth.

[3] The share of the financial sector is measured by the ratio of value added generated by banking and insurance activities to GDP.

financial sector reforms, introduced since 1990, and explain why their impact has been limited so far. It then will suggest measures that could help improve the efficiency of financial intermediation and enhance the financial sector's contribution to growth.

Box I.1: Financial Development and Economic Growth

Financial sector developments are critical to long-run economic growth. A number of economic studies have focused on exploring the channels through which financial development stimulates economic growth in the long-run (see Levine (1997), for a review of the literature). Most of these studies offered detailed arguments and evidence that a well- functioning financial system promotes economic growth by: (i) increasing the amount of financial savings through mobilization of financial resources; (ii) channeling these resources to the most profitable users, thus enabling an efficient allocation of resources; and (iii) ensuring an efficient operation of financial intermediaries by enabling them to operate at the lowest costs. Furthermore, a sound financial system benefits growth indirectly by ensuring a better transmission of monetary signals. These conclusions are also supported by various econometric studies, both time-series and cross-country (see Rousseau and Wachtel (1998); Beck et. al. (2000); Kularatne (2001)). For instance, Levine (1999) found from his cross-country study that a 10 percentage point increase in financial deepening (proxied by the credit to the private sector in percent of GDP) is likely to increase total factor productivity by about half a percentage point. Previous studies, such as Levine (1997), also found that legal and accounting reforms that strengthen creditors rights, contract enforcement, and accounting practices can boost financial development and accelerate economic growth.

While confirming the positive correlation between financial development and economic growth, **some other studies found solid evidence suggesting that the direction of the causality is very much country specific, and not necessarily from financial development to economic growth.** For example, Demetriades and Houssein (1996) investigated a 16 country sample [1] and found (i) very little support for the view that finance is a leading factor in economic development; (ii) that in quite a few countries, economic development causes financial development; and (iii) strong support of the view that the relationship between financial development and economic growth is bi-directional. Similar conclusions were drawn by Luintel and Khan (1999), who examined the long-run causality between financial development and economic growth in a multivariate time-series framework using data from a 10 country ample[2] and found that (i) in the long run, financial depth is positively and strongly affected by the levels of per capita real income and the real interest rate; and (ii) a bi-directional causality between financial development and economic growth in all the sample countries analyzed.

[1] These countries are Costa Rica, El Salvador, Greece, Guatemala, Honduras, India, Korea, Mauritius, Pakistan, Portugal, South Africa, Spain, Sri Lanka, Thailand, Turkey, and Venezuela.

[2] These countries are Colombia, Costa Rica, Greece, India, Korea, Malaysia, the Philippines, Sri Lanka, South Africa, and Thailand.

II. The Currency Board

4. **Djibouti has had a currency board arrangement (CBA) since 1949, at a time when it still was a French territory.** It is operated in a pure form, with foreign reserves being maintaned in excess of the value of the monetary liabilities issued by the Central Bank of Djibouti (BCD). The BCD does not exercise lender-of-last-resort (LOLR) functions, nor does it extend credit to the government, the banking system, or domestic companies (Box I.2) provides a general overview of CBA). Since its creation in March 1949, the Djibouti franc has been pegged to the U.S. dollar. It was revalued twice, in 1971 and 1973. As a result, the exchange rate is now DF 177.7 for one U.S. dollar, down from DF 214.4 for one U.S. dollar before 1971.

5. **The CBA enabled Djibouti to maintain full convertibility into the U.S. dollar at a fixed exchange rate despite economic uncertainties throughout the 1980s and 1990s. It also allowed the country to emerge, on occasions, as a regional commercial and financial center.** Over the years, the CBA has lent credibility to the country. While the government tried to maintain the integrity of the system, it occasionally turned away from the budget deficit financing constraints the CBA required. Nevertheless, the central bank kept the system consistent with external monetary developments, including monetary policy set by the U.S. Federal Reserve Bank. Operating under a 100 percent foreign reserve requirement and utilizing rule-bound monetary policy, transparency, and protection from political pressure, the CBA has helped Djibouti to maintain a relatively strong currency.

6. **By binding its supply of base money closely to its holdings of reserve assets, the CBA has also served Djibouti well in keeping inflation at a low level,** as it has in most countries where such an arrangement has been adopted.[4] The inflation, as measured by the consumer price index, declined continuously from about 7 percent in 1991 to about 0.6 percent in 2002.[5] Djibouti's inflation evolved broadly in line with that of its main trading partners (Figures I.1a and I.1b), with the exception of Yemen, which experienced much higher price increases especially during the period 1995–2002 when inflation averaged 18 percent per year.

---

[4] Based on a large sample of developing countries, Beaney and Fielding (2002) found that the 52 pegged exchange rate countries averaged inflation rates far lower than those experienced by the 28 flexible-rate countries. The standard deviation of output growth is on average a little higher under pegged rates. The standard deviation of inflation is, however, much higher in the flexible-rate sample.

[5] Although the Djibouti franc is anchored to the U.S. dollar, it is worth noting that consumer price indices (CPIs) for Djibouti and the United States have evolved at different rates, with inflation in the United States significantly lower and less volatile from 1990—99 and slightly higher than in Djibouti thereafter. The difference in inflation trends may reflect the difference in the mix of goods produced and consumed, as well as well demand or supply shocks in the two countries.

Box I.2: Conditions and Policy Implications for Currency Board Arrangement

A Currency Board Arrangement (CBA) maintains a permanently fixed exchange rate backed by the firm promise of the government of the establishing country to issue or redeem the local currency at a fixed rate against a foreign "anchor" currency. As a result, the money supply adjusts to the level of official gold and the inflows and outflows of foreign currency reserves, expanding or accelerating when there are net inflows, and contracting or decelerating when there are net outflows. The trigger for these monetary changes is typically price or interest rate differentials with the anchor currency economy (see Enoch and Gulde (1997), and Hanke and Schuler (2000), among other studies dealing with CBAs).

Advantages and disadvantages of a CBA

One of the main advantages of a CBA is that compared to a full-fledged central bank, it is a cost-effective way of managing a monetary system. The CBA is also a strong, "double-barreled" device. Through the currency peg, it indicates a commitment to price stability, while at the same time refraining from being a lender-of-last-resort or expanding domestic credit. However, a CBA precludes the government from using monetary and fiscal policy to help offset economic cycles, especially on the downside. It also effectively removes both exchange rates and interest rates as instruments of government policy, surrendering them to the objectives of external exchange rate stability. Thus, the exchange rate is no longer a policy instrument that may be used to stimulate exports when needed, or to limit imported inflation when it threatens to raise domestic interest rates.

Key factors for successful currency board operations

A successful CBA is predicated on several conditions. First, the peg should be appropriate and supportive of acceptable levels of external competitiveness. The currency involved in the peg should be appropriate from the point of view of the country's external trading pattern. Ideally, the reserve currency should be that of the country's largest trading partner and largest potential source of new foreign investment. A second requirement is that there should be adequate flexibility in goods and factor markets e.g., in prices, wages, and economic structure to keep the system from breaking. Laws and regulations that protect domestic labor and keep labor costs high, including through costly social security contributions and other constraints, prevent the efficient reallocation of labor among industries. Third, there must be a free flow of goods and services, in addition to capital, across international borders to allow the price level to adjust fully to changes in the flows of international reserves. A fourth requirement is that a CBA should have adequate financial market supervision, risk assessment, and management so that financial institutions will be able to withstand the consequences of external shocks on interest rates. At the same time, bank supervision should follow best international practices in order to ensure high standards of bank governance and management, adequate loan loss provisioning, and ongoing supervision of balance sheet risks (e.g., currency and maturity matching). In this regard, adequate official reserves are only one critical element of the preservation of confidence. A final necessity is that a CBA should maintain fiscal prudence, which implies a sound fiscal framework that does not require discretionary access to central bank financing by the general government, while maintaining public debt within limits of serviceability (see acccompanying paper on fiscal issues).

Box I.2: Conditions and Policy Implications for Currency Board Arrangement (concluded)

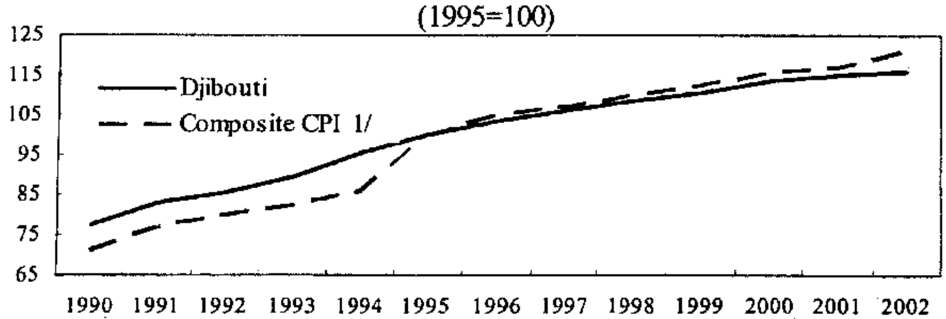
Policy Implications

For a CBA to be successful, the fixed exchange rate must be the sole fixed point surrounded by highly flexible, market-oriented systems. The maintenance of the currency board must be the top priority, with other policies designed to support it, not conflict with it. Any government's reluctance or inability to conform to either the hard budget constraints or the free market principles which must accompany the adoption of a currency board would compromise the effectiveness of the CBA.

To what extent are the key factors for successful CBA operations met in Djibouti?

Djibouti has long maintained a fully open trade system with free capital transactions, and virtually zero external tariff. Also, the liquidity constraint, implied by the lack of a lender-of-last-resort, did not pose problems to banks that are subsidiaries of large foreign banking groups, access to international financing. Domestic banks with no such access, on the other hand, went through a liquidity crisis and were liquidated. Additionally, improvements to bank supervision over time have enhanced standards of bank governance and management, adequate loan loss provisioning, and ongoing supervision of balance sheet risks (currency and maturity matching etc). In this respect, the maintenance of adequate official reserves is only one critical element in the preservation of confidence. However, there is a lack of flexibility in other markets and prices that should accompany the holding of the value of the domestic currency absolutely fixed. In particular, Djibouti delayed the dismantling of many laws and regulations protecting domestic labor. Labor costs are very high for the region, and include onerous social security contributions, large severance payments, and other constraints that prevent the efficient re-allocation of labor between industries and downward adjustment in wages. Furthermore, fiscal discipline was not always observed, as evidenced by the accumulation of large amounts of domestic and external arrears during the 1990s.

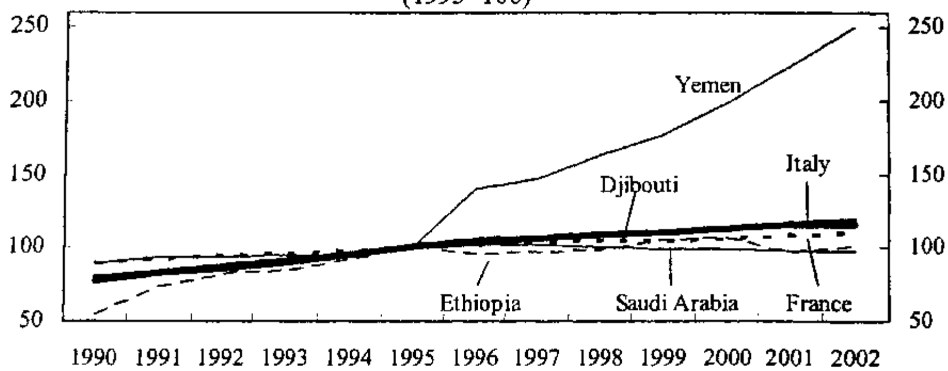
Figure I.1a. Djibouti and Trading Partner Countries: CPI indices, 1990–2002 (1995=100)



Sources: IMF, *Information Notice System* ; and staff calculations.

1/ The composite CPI is a weighted average of Djibouti's main trading partners' CPI (Ethiopia, France, Italy, Saudi Arabia, United Kingdom and Yemen) using their trade share as weights.

Figure I.1b. Djibouti and Trading Partner Countries: CPI indices, 1990–2002
(1995=100)



Sources: IMF, *Information Notice System*.

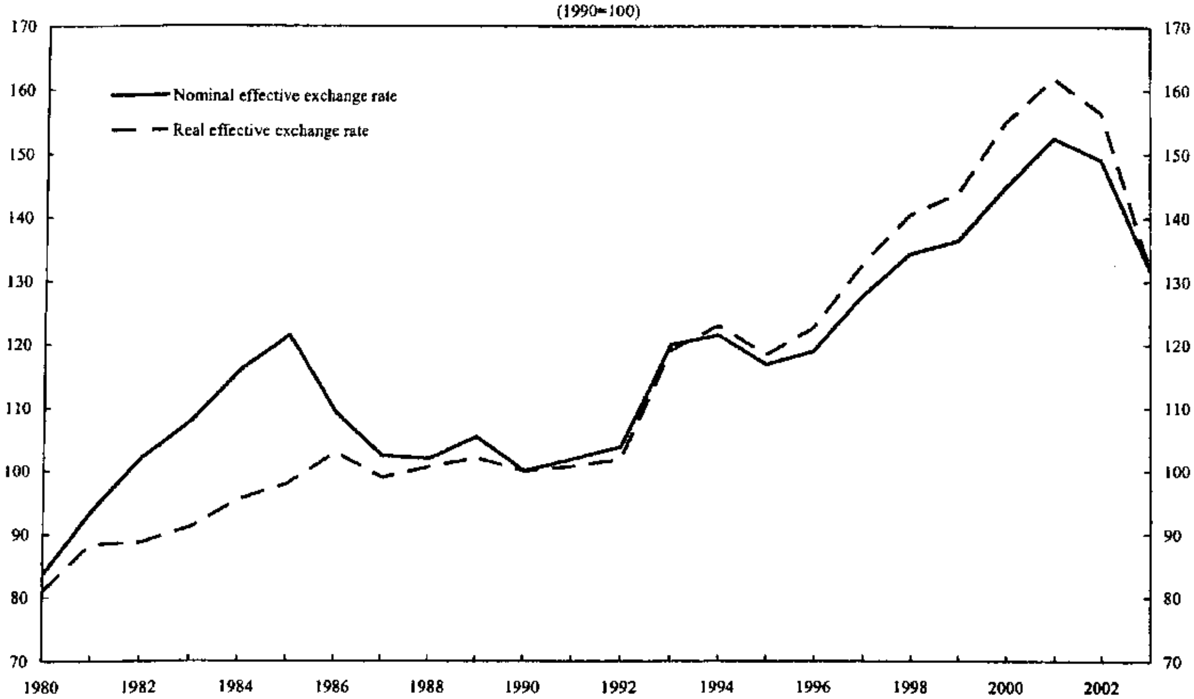
7. **Between 1990 and 2002, the hard peg to the dollar did not allow the economy to adjust as easily to external financial and real shocks.** Included among these factors are oil shocks that affected the gulf countries, business cycles in other trading partner countries in Europe and in neighboring countries (especially Ethiopia and Yemen) and interest rate fluctuatations in the United States. Thus, while other countries in the region, most of which are potential competitors, experienced large exchange rate depreciations, Djibouti's currency appreciated in effective terms (Figure I.2) and interest rates rose at a time when its economy was already suffering from recession, a loss of external competitiveness, and a worsening of the trade balance. Sticky wages and prices prevented the necessary adjustments to these shocks and further complicated the situation.

8. **Notwithstanding the advantages of full convertibility of the Djibouti franc, other factors (including real effective exchange rate misalignment, an unfavorable business environment, and rigidities in the labor market) hindered foreign investment and economic growth.** Looking at the period from 1990 to 2002, foreign investment remained below 1 percent of GDP. Real GDP declined by about half a percent on average per year and unemployment soared with more than half of the labor force out of work, leading to declining per capita income and rising poverty. At the same time, the real effective exchange rate appreciated by about 60 percent and interest rates remained at high levels.

9. **Macroeconomic policies implemented by Djibouti during the 1980s and 1990s were not always consistent with the maintenance of a fixed exchange rate.** In particular, against a background of civil strife, fiscal policy was expansionary and substantial payment arrears were accumulated. Fiscal reforms and other structural reforms stalled. Moreover, the labor market was rigid and the external competitiveness of the economy was slowly eroded, putting, at times, some pressure on the CBA. Thus, between 1994 and 1997 reserve adequacy ratios, measured by the monetary base (M1)/foreign reserves and broad money (M2)/foreign resersves, increased by 7 percent (from 0.73) and 15 percent (from 1.18), respectively. At the same time, foreign currency deposits increased by 19 percent and their share in total deposits increased by about 15 percentage points (from 48 percent) pointing to some loss of confidence in the Djibouti franc during this period. There was also marked private capital outflows, as witnessed by negative BOP errors and omissions (including short-term capital flows) averaging 7 percent of GDP per year from 1996 to 1998. Consequently, two domestic

banks ceased operations in 1999 after they failed to survive liquidity constraints and competition from two foreign-owned banks which had access to financing from their headquarters.

Figure I.2. Djibouti: Exchange Rate Developments, 1980–2003 1/
(1990=100)



1/ Data for 2003 are upto June only.

10. **Starting in 1998, domestic and external factors helped reinforce the CBA.** On the domestic level, the reestablishment of fiscal discipline and the implementation of some reforms, in the fiscal and other areas, contributed to curb and then reverse the rising trend in domestic budgetary arrears. In addition, external factors that generated additional resources and improved Djibouti's economic situation, have included increased transit trade with Ethiopia, following the war between Ethiopia and Eritrea, resumption of sustained external support (program-related funding by the World Bank, Fund programs, European Union, and France) and the financial windfall received by Djibouti for its cooperation in the fight against terrorism. However, the deeply rooted respect for the CBA within the Djibouti society and political structure has played a significant role in the maintenance of the CBA.

III. The Financial System

11. **In addition to the CBA, the Djibouti financial system today consists of three commercial banks and a limited number of nonbank financial institutions.** The latter include six money changers and two insurance companies dealing in car, business, and various shipping-related insurance services.[6] There is no domestic capital market that could

[6] About eight insurance companies existed before December 2000, when a new regulatory law, promulgated a year earlier, came into effect. Most of these companies fell short of

(continued)

bring together entrepreneurs and investors, who would seek placement opportunities and be prepared to take risks.

A. The Banking System

Current setting and features

12. **The Djibouti financial sector has remained confined to providing short-term financial services and performed weakly in comparison with other small states and neighboring countries.** For illustration purposes, Table I.1 presents comparative data on financial depth of Djibouti vis-à-vis other small states and neighboring countries (Ethiopia, Yemen, and Egypt), and two African countries (Ghana and Kenya). This table indicates that Djibouti's performance was weaker than most of its comparators on most indicators between 1990 and 2002: it experienced a lower financial intensity as evidenced by lower broad money growth, broad money-to-money ratio, growth of credit to the private sector, growth of total deposits, and lower share of time deposits in total deposits.[7] During the same period, real GDP growth declined about 0.5 percent per year in Djibouti, while annual growth reached an average of 3.5 percent in the other small states and even higher levels in the other comparator countries.

13. **Financial intermediation in Djibouti is fairly weak and dominated by foreign-owned banks.** Following the closures of two other commercial banks (*Banque Al-Baraka* and Banque de *Djibouti et du Moyen Orient* (BDMO)) in the late 1990s, owing to continued liquidity problems, the banking sector is now dominated by two large French-owned commercial banks, *Banque Pour le Commerce et l'Industrie Mer Rouge* (BCI) and *Banque Indosuez Mer Rouge* (BIS), which together account for about 95 percent of total deposits and issue more than 85 percent of total credit. As a result of a weakened loan portfolio, activities of the third operating bank, the local subsidiary of the *Commercial Bank of Ethiopia* (CBE), are largely limited to deposit-taking and international transactions conducted by Ethiopian customers.

14. **Financial intermediation is costly to those soliciting funds and lending practices aimed at minimization of risks.** For instance, the banks demand marketable collateral in a country where assets are few and illiquid. Also, the spread between lending rates and deposit rates is high and almost twice what prevails in neighboring Ethiopia, and a percentage point higher than spreads in Yemen and in other small states. As a result, the two large commercial banks operate very much like traditional savings banks (*caisse d'épargne*), with a focus on deposit collection and only very limited credit activity. Credit to the private sector has been declining due to limited opportunities in the real sector, deficiencies in accounting standards, and a weak judicial system. Gradually, banks have shifted the structure of their assets toward foreign assets held with their parent companies.

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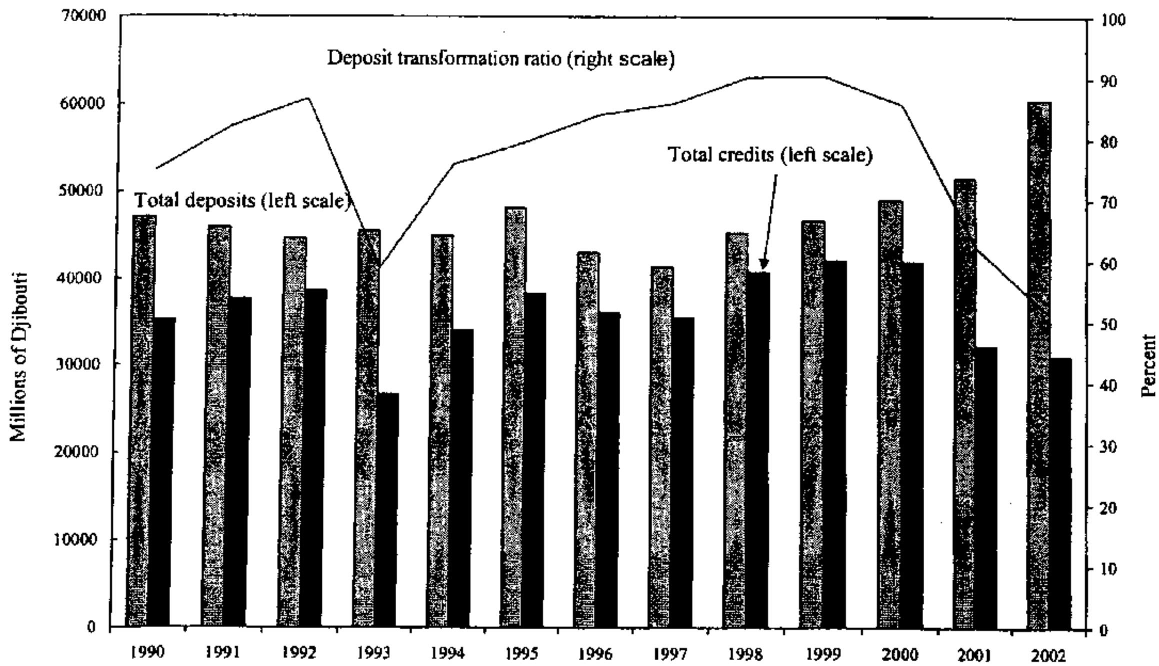
meeting the new requirements (e.g., in terms of technical reserves, assets, liabilities, and tariffs) and were constrained to cease activities.

[7] Appendix I provides a detailed overview of monetary developments from 1990 to 2002.

15. **Bank lending remained low, exhibiting some volatility in the early 1990s, and has been declining since 1999, despite a noticeable increase in deposits during the same period.** The deposit transformation rate,[8] depicted in Figure I.3 below, remained above 70 percent during most of the 1990s but has been declining sharply since 1999, reaching about 50 percent in 2002, down from a peak of 90 percent in 1999. This trend may be explained mainly by uncertainty about government policies, law investment profitability in Djibouti, and a slowdown in trade activities.

Figure I. 3. Djibouti: Total Bank Deposits and Credits, 1990—2002



Source: Djibouti authorities; and Staff calculations.

16. **Bank lending distribution is reasonably concentrated in terms of beneficiaries, activities, maturities, and the customer base remains modest.** About 60 percent of total loans are extended to the trading sector and 19 percent to individuals (mostly for mortgages), while industry and energy receive barely 7 percent of these loans (Figure I.4 and Table I.3).[9] Short-term lending represents about 75 percent of total lending, and long-term lending averages about 10 percent. It is also estimated that the two main commercial banks together have about 150 large customers with a credit volume exceeding DF 15 billion; their relations with the largest 50 customers play a key role in determining overall lending volumes.

[8] The deposit transformation rate is defined as the ratio of total credits to total deposits.

[9] The Djibouti Development Bank (BDD) was the only specialized bank in providing long-term credit and equity to the real sector. The BDD was liquidated in 2000.

17. **Banks lend primarily to the trading community, and loans are not easily available to other customers such as small businesses.** Against the background of economic uncertainties, lack of profitable projects, and increasing nonperforming loans (NPLs), commercial banks are cautious when granting credit and impose stringent conditions when they do so. As a result, small operators, particularly those engaged in the informal sector, do not have access to bank lending because they often fall short of meeting all the stringent qualification criteria set by banks. In the absence of alternative sources of financing, small projects that are more commensurate with the size of domestic markets, and which can be labor-intensive, are often abandoned.

18. **To promote access to financing for small, long-term projects, the authorities established in 1983 the Djibouti Development Bank (BDD),** which was the only specialized bank in Djibouti. The BDD faced serious difficulties mainly due to poor supervision and increased government interference in its operations. As a result, the assets of the BDD were frozen beginning in 1996, owing to the growing number of NPLs in its portfolio, and an early dissolution of the BDD was decided in 2000. More recently, the government authorized, in 2001, the creation of a Development Fund for Djibouti (FDD) to promote access to credit for small- and medium-sized companies. The FDD's objective is to grant direct loans, using its own funds and resources borrowed overseas, to private sector operators, especially in the tourism, fisheries, and agriculture sectors, with priority given to rural development and microcredits. Its mission is also to provide technical assistance in the area of project development. However, the FDD is not yet fully operational.

Table I.1 Djibouti: Selected Financial Indicators, 1990–2002

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	Average (1990–2002)
Broad money growth (Annual percentage change)														
Small states 1/ 2/	19.8	15.6	13.9	13.8	26.8	18.3	13.5	18.6	9.5	12.3	15.4	10.2	10.3	15.2
Djibouti	3.6	1.3	-6.2	-2.2	1.5	3.3	-10.0	-1.4	-2.8	5.2	1.1	7.5	15.7	1.3
Egypt	28.7	19.3	19.4	13.2	11.2	9.9	10.8	10.8	10.8	5.7	11.6	13.2	12.6	13.6
Ethiopia	18.5	17.0	16.2	9.8	25.3	8.7	8.1	15.0	-3.0	6.7	14.2	9.8	13.3	12.3
Ghana	13.3	39.1	52.3	33.5	52.6	43.2	39.2	44.1	17.5	25.4	54.2	31.7	48.9	38.1
Kenya	20.1	19.6	39.0	28.0	31.5	24.8	25.4	18.7	2.6	6.0	4.5	2.5	11.7	18.0
Yemen, Republic of	-	11.3	20.9	31.1	32.5	50.7	8.1	11.2	11.8	13.8	25.3	18.8	17.5	21.1
Ratio of broad money to GDP (In percent)														
Small states	49.8	51.9	49.6	49.8	50.4	51.7	52.7	54.6	56.5	56.5	59.2	61.0	63.0	54.3
Djibouti	73.2	72.5	65.8	66.0	63.6	64.9	58.8	57.0	54.1	54.6	53.5	55.5	62.2	61.7
Egypt	85.9	87.5	84.5	84.7	84.6	79.8	78.6	77.7	77.0	76.0	76.7	82.4	87.2	81.7
Ethiopia	42.6	43.7	46.9	40.1	47.3	43.0	41.5	40.0	39.2	38.5	41.1	44.3	42.3	42.4
Ghana	13.4	15.6	20.5	19.8	22.5	21.6	20.6	23.8	22.8	24.1	28.4	26.7	31.0	22.4
Kenya	29.7	31.0	36.5	37.1	40.6	43.6	48.1	48.4	44.6	44.2	43.1	39.8	40.5	40.6
Yemen, Republic of	55.5	51.5	48.7	51.4	52.4	47.5	36.2	33.5	39.0	32.4	30.9	34.7	37.4	42.4
Ratio of broad money to money (In percent)														
Small states	3.0	3.1	3.1	3.1	3.2	3.3	3.3	3.4	3.5	3.3	3.4	3.4	3.4	3.3
Djibouti	2.1	1.9	1.7	1.6	1.6	1.7	1.6	1.7	1.8	1.7	1.9	2.0	1.8	1.8
Egypt	3.1	3.5	3.8	3.9	3.9	3.9	4.1	4.1	3.8	4.0	4.2	4.4	4.4	3.9
Ethiopia	1.4	1.4	1.4	1.4	1.5	1.6	1.7	1.8	1.9	1.8	1.9	2.0	2.0	1.7
Ghana	1.3	1.6	1.6	1.7	1.7	1.8	1.9	1.9	1.8	2.0	2.2	2.0	1.9	1.8
Kenya	2.1	2.2	2.1	2.1	2.4	2.9	3.2	3.3	3.3	3.0	2.9	2.8	2.6	2.7
Yemen, Republic of	1.2	1.2	1.2	1.2	1.2	1.5	1.7	1.8	1.8	1.8	1.9	2.0	2.1	1.6
Credit to private sector growth (Annual percentage change)														
Small states	17.8	16.5	15.1	16.1	17.8	20.4	16.7	24.8	14.9	10.4	10.7	8.7	16.3	15.9
Djibouti	-5.1	-3.0	-1.3	-6.2	2.0	13.2	2.7	-0.9	9.1	-34.7	14.3	-14.4	-4.7	-2.2
Egypt	19.7	1.5	24.8	19.1	32.4	36.8	25.5	25.9	26.8	19.6	10.5	11.5	5.1	19.9
Ethiopia	5.0	0.5	52.0	116.2	47.3	86.4	74.0	24.2	8.6	29.0	5.5	3.0	-1.1	34.7
Ghana	14.3	-6.2	56.0	35.2	45.9	43.9	73.1	69.9	37.6	60.4	46.9	18.9	30.3	40.5
Kenya	11.9	22.1	30.9	5.3	27.7	48.9	24.4	24.9	0.4	10.8	3.8	-4.0	2.8	16.1
Yemen, Republic of	-	12.7	15.3	26.0	11.8	68.7	-6.3	53.8	33.7	35.8	21.3	25.8	14.3	26.1
Total deposit growth (Annual percentage change)														
Small states	12.6	14.2	18.2	14.1	19.4	19.6	17.7	19.8	11.2	12.0	15.1	12.6	17.4	15.7
Djibouti	2.8	1.8	-11.4	-0.6	1.2	7.8	-12.7	-1.1	8.5	-5.0	1.6	8.8	17.1	1.4
Egypt	30.7	23.3	21.6	12.7	10.7	10.1	11.1	10.5	7.0	7.4	12.8	14.3	12.5	14.2
Ethiopia	10.2	7.2	15.1	17.6	35.4	10.4	16.8	27.0	3.4	4.8	18.1	10.8	12.4	14.6
Ghana	20.0	55.8	42.1	39.2	47.4	40.6	42.6	48.2	16.9	16.2	38.0	55.8	47.8	39.3
Kenya	13.6	20.3	34.5	27.9	37.8	27.7	26.7	17.7	2.2	4.8	4.9	4.2	9.3	17.8
Yemen, Republic of	-	11.6	17.5	16.2	15.5	112.2	22.2	16.5	20.0	14.4	32.0	23.3	25.3	27.2
Ratio of Time deposits to total deposits (In percent)														
Small states	70.6	70.8	70.6	70.0	70.7	70.6	70.2	70.0	71.0	68.8	69.2	69.0	70.9	70.2
Djibouti	63.7	58.7	51.6	49.9	51.4	55.9	55.3	57.8	55.2	50.9	56.9	59.2	59.2	55.8
Egypt	83.8	84.7	86.1	86.8	87.3	87.5	88.3	88.9	89.4	89.5	90.1	90.7	90.5	88.0
Ethiopia	46.4	49.9	51.7	54.9	54.6	59.8	64.1	62.6	62.0	59.5	59.5	62.3	61.9	57.6
Ghana	37.1	51.8	55.1	56.6	59.8	67.0	69.7	66.8	64.6	72.3	82.2	72.2	67.4	63.3
Kenya	64.6	66.4	65.3	65.6	70.9	77.4	80.3	82.0	82.0	79.4	77.5	74.7	73.7	73.8
Yemen, Republic of	50.3	50.3	45.3	44.5	43.3	75.8	76.4	78.6	80.6	84.0	83.3	83.6	86.8	67.9

Sources: Djibouti authorities; and IMF, *International Financial Statistics* and *World Economic Outlook*.

1/ Small States are: Antigua and Barbuda, The Bahamas, Bahrain, Barbados, Belize, Bhutan, Botswana, Cape Verde, Comoros,Cyprus, Dominica, Equatorial Guinea, Estonia, Fiji, Gabon, The Gambia, Grenada, Guinea-Bissau, Guyana, Maldives, Malta, Mauritius, Qatar, Samoa, São Tomé & Principe, Seychelles, Solomon Islands, St. Kitts and Nevis, St. Lucia, St. Vincent & Grens., Suriname, Swaziland, Tonga, Trinidad and Tobago, and Vanuatu.

2/ Simple average.

Table I.2. Djibouti: Selectoral Distribution of Credits1/

(In millions of DF)

	1997	1998	1999	2000	2001	2002
Individuals	4,839	5,517	6,739	6,121	7,087	4,943
Agriculture and fishing	0	0	0	0	0	0
Industries	1,302	2,337	2,742	2,918	2,389	1,717
Construction	2,138	1,676	1,747	1,463	1,377	440
Commerce	19,174	16,967	17,679	18,595	17,181	14,854
gas retailers, vehicules,	1,987	2,266	2,119	2,095	1,468	2,094
consumption goods	17,187	14,701	15,561	16,500	15,713	12,760
Hotels and restaurants	193	267	1,638	1,999	417	210
Transport and communication	736	1,677	2,162	748	753	855
Government	1,747	785	218	248	552	783
Other sevices	1,207	1,098	2,887	2,620	1,501	1,254
Total	31,335	30,324	35,812	34,711	31,257	25,057
			(In percent of total credits)			
Individuals	15.4	18.2	18.8	17.6	22.7	19.7
Agriculture and fishing	0.0	0.0	0.0	0.0	0.0	0.0
Industries	4.2	7.7	7.7	8.4	7.6	6.9
Construction	6.8	5.5	4.9	4.2	4.4	1.8
Commerce	61.2	56.0	49.4	53.6	55.0	59.3
gas retailers, vehicules	6.3	7.5	5.9	6.0	4.7	8.4
consumption goods	54.8	48.5	43.5	47.5	50.3	50.9
Hotels and restaurants	0.6	0.9	4.6	5.8	1.3	0.8
Transport and communication	2.3	5.5	6.0	2.2	2.4	3.4
Government	5.6	2.6	0.6	0.7	1.8	3.1
Other sevices	3.9	3.6	8.1	7.5	4.8	5.0
Total	100.0	100.0	100.0	100.0	100.0	100.0
			(Annual changes in percent)			
Individuals	-	14.0	22.1	-9.2	15.8	-30.2
Agriculture and fishing	-	-	-	-	-	-
Industries	-	79.5	17.3	6.4	-18.1	-28.1
Construction	-	-21.6	4.2	-16.3	-5.9	-68.1
Commerce	-	-11.5	4.2	5.2	-7.6	-13.5
gas retailers, vehicules, ...	-	14.0	-6.5	-1.1	-29.9	42.7
consumption goods	-	-14.5	5.8	6.0	-4.8	-18.8
Hotels and restaurants	-	38.2	513.1	22.1	-79.2	-49.5
Transport and communication	-	127.9	28.9	-65.4	0.8	13.5
Government	-	-55.1	-72.2	13.5	122.8	42.0
Other sevices	-	-9.0	162.9	-9.2	-42.7	-16.4
Total	-	-3.2	18.1	-3.1	-10.0	-19.8

Source: Central Bank of Djibouti.

1/ Beneficiaries, for 1997–2000 credits of 10 million DF and more are listed; and from 2001 credits of 3 million DF and more are listed.

2/ Preliminary figures for 2002, as of October 2002.

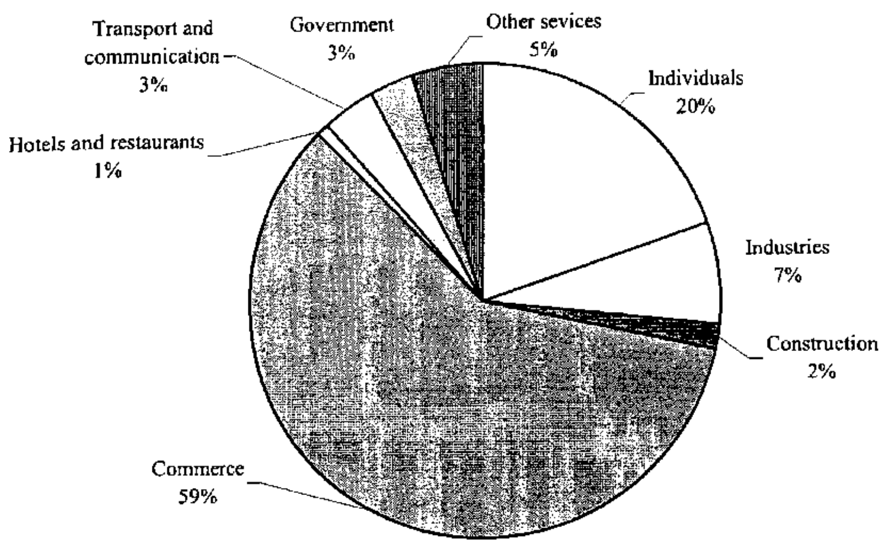
Table I.3. Djibouti: Deposits Structure, 1990–2002

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
						A. Structure by maturity							
						(In millions of Djibouti francs)							
Short-term deposits	15,929	17,924	20,543	22,068	20,729	19,765	18,437	15,730	17,783	19,862	18,500	17,311	24,225
Medium-term deposits	1,827	2,187	3,109	2,968	3,065	2,862	2,958	3,160	3,334	3,506	3,783	4,324	4,651
Long-term deposits	22,910	19,573	15,401	13,507	13,101	13,348	10,577	10,820	10,955	9,891	11,168	12,223	12,563
Cash bond/voucher	6,417	6,191	5,589	6,843	8,014	12,105	11,056	11,605	13,170	13,334	15,542	17,689	19,089
Total banking system	47,083	45,876	44,642	45,386	44,908	48,080	43,027	41,314	45,242	46,593	48,993	51,547	60,528
						(In percent of total deposits)							
Short-term deposits	33.8	39.1	46.0	48.6	46.2	41.1	42.8	38.1	39.3	42.6	37.8	33.6	40.0
Medium-term deposits	3.9	4.8	7.0	6.5	6.8	6.0	6.9	7.6	7.4	7.5	7.7	8.4	7.7
Long-term deposits	48.7	42.7	34.5	29.8	29.2	27.8	24.6	26.2	24.2	21.2	22.8	23.7	20.8
Cash bond/voucher	13.6	13.5	12.5	15.1	17.8	25.2	25.7	28.1	29.1	28.6	31.7	34.3	31.5
Total banking system	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
						(Annual changes in percent)							
Short-term deposits	-	12.5	14.6	7.4	-6.1	-4.7	-6.7	-14.7	13.1	11.7	-6.9	-6.4	39.9
Medium-term deposits	-	19.7	42.2	-4.5	3.3	-6.6	3.4	6.8	5.5	5.1	7.9	14.3	7.6
Long-term deposits	-	-14.6	-21.3	-12.3	-3.0	1.9	-20.8	2.3	1.3	-9.7	12.9	9.4	2.8
Cash bond/voucher	-	-3.5	-9.7	22.4	17.1	51.1	-8.7	5.0	13.5	1.2	16.6	13.8	7.9
Total banking system	-	-2.6	-2.7	1.7	-1.1	7.1	-10.5	-4.0	9.5	3.0	5.2	5.2	17.4
						B. Structure by Depositor							
						(In millions of Djibouti francs)							
Individuals	18,946	15,883	16,469	15,194	15,334	15,912	13,802	14,956	15,417	15,326	16,195	16,483	17,652
Private companies	8,335	10,432	11,701	12,266	9,921	9,438	9,283	8,573	10,698	12,759	21,844	23,780	14,677
Public enterprises	10,016	9,160	5,719	5,890	6,662	5,135	3,255	1,988	1,376	1,157	1,763	1,660	2,458
Others	9,786	10,401	10,753	12,036	12,991	17,595	16,687	15,798	17,752	17,351	9,192	9,623	25,742
						(In percent of total deposits)							
Individuals	40.2	34.6	36.9	33.5	34.1	33.1	32.1	36.2	34.1	32.9	33.1	32.0	29.2
Private companies	17.7	22.7	26.2	27.0	22.1	19.6	21.6	20.8	23.6	27.4	44.6	46.1	24.2
Public enterprises	21.3	20.0	12.8	13.0	14.8	10.7	7.6	4.8	3.0	2.5	3.6	3.2	4.1
Others	20.8	22.7	24.1	26.5	28.9	36.6	38.8	38.2	39.2	37.2	18.8	18.7	42.5
						(Annual changes in percent)							
Individuals	-	-16.2	3.7	-7.7	0.9	3.8	-13.3	8.4	3.1	-0.6	5.7	1.8	7.1
Private companies	-	25.2	12.2	4.8	-19.1	-4.9	-1.6	-7.6	24.8	19.3	71.2	8.9	-38.3
Public enterprises	-	-8.5	-37.6	3.0	13.1	-22.9	-36.6	-38.9	-30.8	-15.9	52.4	-5.8	48.0
Others	-	6.3	3.4	11.9	7.9	35.4	-5.2	-5.3	12.4	-2.3	-47.0	4.7	167.5

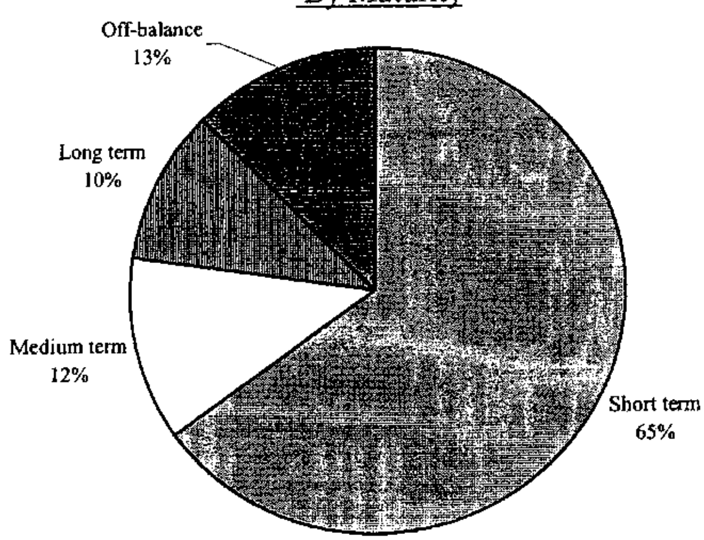
Sources: Djibouti authorities; staff calculations.

Figure I.4. Djibouti: Credit Distribution, October 2002

By Economic Activity



By Maturity



Sources: Central Bank of Djibouti; and staff estimates.

19. **Current trends in bank lending are also determined by the structure of demand for credit.** In addition to enterprises eligible for banks's financing, there are, in Djibouti, two major categories, which potentially need financing but are excluded from bank financing. The first group includes operators performing low income-generating activities (such as small traders, small handicrafts, and service providers, which are usually self-run) and responds to demands for goods and services by low income and poor families in a flexible way and at competitive prices. These operators are excluded from bank credit because the amount of loans they require is usually low and incur high transaction costs that banks are unwilling to assume. Additionally, the absorption capacity of these operators is low in view of the their limited activity and, because of their precariousness, they cannot provide the collateral required by banks. The second group includes investors with some financing capacity, who are eligible for development funds. While they are capable of applying to banks for credit, these operators are discouraged by banks' stringent conditions and collateral requirements. Banks could increase their operations with these operators if (i) the juducial system became more efficient and responded in a timely manner, leading banks to soften their conditionality; and (ii) adequate financial products and a regulatory framework are developed.

The soundness of the banking system

20. **While available data indicate that Djibouti's financial system is broadly sound, in the recent past, the quality of bank assets was negatively affected by weak economic developments in Djibouti, sharp declines in the housing market, and political conflicts in neighboring countries.** For the banking system as a whole, the share of NPLs (including provisions for NPLs) increased from about 23 percent in the 1990s to about 26.5 percent at end-2002. Capital adequacy and risk diversification ratios were generally met by the two dominant commercial banks, BCI and BIS.[10] At the same time, there were some differences in terms of risk exposure and performance between the two banks. While the share of NPLs to total loans is similar in both banks, they differ in terms of loan loss provision. Reflecting partly higher provisions for loan losses in one bank, return on equity and return on assets were lower than the other bank. Overall, profitability of banks has remained low on account of the still substantial amount of NPLs on their books.

21. **In 2002 more than 80 percent of bank revenue came from net interest income.** Limited competition in the small banking sector has helped banks manage their interest income and stabilize profit developments. Because of the small size of the banking market, the monetary authorities have been concerned for a long time that there is a risk of collusion

[10] Both banks follow prudential regulations from their headquarters, which are deemed to be stricter than those imposed by the BCD. Most domestic banks failed to observe prevailing regulations and were victims of non rigourous management, especially in screening and monitoring the beneficiary of loans.

among banks in setting interest rates. In August 1999, the BCD instructed banks to cease their coordination of interest rate structures and to publicize and report their structures to the BCD (section IV). However, recent interest rate developments suggest that banks may still use their market power to some degree. Whereas minimum deposit rates declined from 3.9 percent in 2000 to 1 percent in 2002, in line with international rates, minimum lending rates remained at 10.8 percent, thus further widening the interest rate spreads. Currently, there is no evidence supporting the idea of a liquidity crunch in the Djibouti banking system. There are limited lending opportunities which, coupled with a very cautious lending approach by commercial banks, lead to a significant amount of net foreign assets that are placed by the latter with their parent banks.

22. **Notwithstanding the improvements that took place over the recent years, the banking sector in Djibouti still exhibits a few vulnerabilities that need to be addressed.** First, one of the commercial banks still fails to meet a number of prudential regulations and the other hardly meets any of them. Failure to quickly and decisively address this issue may ultimately have negative effects on the integrity of the banking system. Second, the large share of interest income from foreign assets in revenues (over 25 percent of total revenues) might involve some risks over the medium term, particularly if competition in the banking sector increases. Similar risks may exist if international interest rates remain low over a long period of time. If this were to occur, and if competition in the banking sector were to increase, leading to a narrowing of domestic interest margins may narrow (given the tight link of domestic rates to international rates) and banks would have to cut costs or find other sources of income to avoid losses. Recent experience shows, actually, that the two main commercial banks managed to more than offset the decline in interest incomes by increasing commissions and other fees for customers' operations. Third, the liquidity and solvency of the banking system could also be threatened by a banking crisis in the country of origin of the parent institutions or in a major trading partner country of Djibouti. While not very likely, such a crisis would have a large impact on the Djibouti banking system.

B. The Money Changers

23. In addition to the three commercial banks, there are currently six money changers in Djibouti. Some of them have been in operation since 1948, beginning as small enterprises focused on servicing the business of their owner and expanding over time. They often operate in an informal manner, and their operations are traditionally limited to the sub-region and the Arabic peninsula, given Djibouti's dependence on these countries. Their working procedures remain largely outdated despite the increasing volume of activity.

Their role in financial intermediation

24. **The money changers offer currency exchange and international transfer services, even to clients with no bank account.** The currency exchange activity is limited to Djibouti and does not involve transactions with other countries. Nevertheless, when the foreign currencies needed are not available in the domestic banking system, the money changers call upon regional commercial banks to satisfy their need or, in some cases, travel

to purchase and repatriate the needed foreign currencies. For currency transfers, the money changer issues a transfer order to the beneficiary, either a subsidiary in the country of the beneficiary, if any, or order the bank, in which it has an account, to make the transfer in question.

25. **The money changers play an important role in financial intermediation.** Based on the 2001/2002 on-site supervision, the money changers handled about 17 percent of total financial transfers abroad and about 7 percent of transfers received by Djibouti. About 45 and 40 percent of receivable transfers originate from U.A.E and Yemen, respectively, the remaining come mostly from Saudi Arabia and Ethiopia. About 90 percent of these transfers are in U.S. dollars and the rest in Djibouti francs and Ethiopian birrs. The currency composition of transfers payable is about 66 percent in the U.A.E dirham, 20 percent in the Saudi Arabian rial, and 10 percent in the U.S. dollar. The money changers are appealing because they perform several useful functions, as they: (i) operate on somewhat smaller spreads and charge lower commissions than the commercial banks; (ii) deal with all types of customers and are more flexible than banks in terms of working hours; and (iii) are more specialized in their operations than banks, which operate a broader range of activities.

The soundness of money changers

26. **While the responsibility for supervision of the money changers is vested in the BCD, their activities remained largely unmonitored until recently.** After the events of September 11, and in line with the intensification of the international fight against terrorism and money laundering, the BCD launched, in end-2001 and early 2002, a vast on-site supervision of all money changers. To further enhance supervision, the authorities adopted in 2002 a law on money laundering, confiscation, and international cooperation with regard to the proceeds of crime. At the same time, they prepared revised banking laws which provide for more regular on-site supervision and a systematic control of all money changers.[11]

27. The first on-site supervision undertaken in 2001/2002 concluded that **the existing money changers operate broadly in full compliance with the existing regulations and gained a valuable know-how through years of experience.** Most of them rely on correspondent networks that impose sufficient financial guarantees and soundness. Nevertheless, the inspection team of the BCD recommended that the money changers do the following: (i) computerize their data and improve their maintenance; (ii) gradually introduce recent accounting practices to keep up with their growing activities; and (iii) request, if necessary, technical assistance from the BCD regarding accounting and regulatory practices.

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[11] However, the revised banking laws were not yet adopted by the parliament.

C. Informal Financial Arrangements

28. **Outside the formal sector, there also exists informal finance in the form of traditional arrangements.** Informal finance is understood in this context as contracts or agreements conducted without reference or recourse to the legal system in order to exchange primarily cash in the present for promises of primarily cash in the future.[12] These arrangements are used by low-income participants for pooling small savings and extending small credits. Box 1.3 provides an overview of the main features and activities of the three main forms of arrangements existing in Djibouti.

29. **The three forms of traditional arrangements have several advantages and weaknesses.** The success of the informal systems stems principally from ensuring (i) low transaction costs; (ii) supply of loans, savings, and implicit insurance; (iii) services that are sensitive to constraints faced by women, in particular their inability to obtain formal financing; (iv) substitution of confidence in character for physical collateral; and (v) socially enforced and/or self-enforced contracts. While these forms show how those excluded from the banking system fashion their own financial instruments in the absence of formal services, they have several weaknesses that should not be overlooked, including (i) lack of deposit insurance; (ii) operation within a limited group based solely on individual savings and inability to satisfy the financing demands for economic activities which exceed available savings; (iii) limited proportion of savings invested and only on a short-term basis because of its very nature; and (iv) impossibility of recourse to a legal system that enforces contracts.

D. Microcredit Programs

30. Microfinance corresponds, in this context, to **formal schemes designed to improve the well-being of the poor through better access to saving services and loans.** Thus, both informal finance and microcredit aim at serving the poor. However, they differ to the extent that informal finance derives from the need of those excluded from the formal finance for financial services and loans, while microfinance is impulsed by a donor-driven supply of financing. Lessons drawn from informal finance are usually very instructive for the design of microfinance.

31. **Although microfinance in Djibouti started a decade ago, it is still at an early developmental stage.** Microfinance started with the French Development Agency's (AFD) program *(Programmes Aide aux initiatives de Base)*, which benefited, between 1992 and 1995, 32 small- and medium-sized enterprises, engaged in activities such as hotels, fisheries, bakeries, and small manufacturing enterprises. The project failed for various reasons, including the absence of reliable information about the solvency of beneficiary firms; the lack of experience of the AFD in microfinance; insufficient human and financial resources to

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[12] Informal finance can be seen as a positive reaction to the inadequacy and lack of flexibility of the banking sector with regard to low and irregular income earners.

manage and monitor the program; and a judicial system lacking the ability to enforce contracts, as evidenced by the fact that only two enterprises have fully reimbursed their loans.

Box I.3. Informal Financial Arrangements[1]

Three forms of arrangements exist in Djibouti. The first traditional arrangement is revolving savings and credit associations, also known as *tontines*. The most widespread type in Djibouti is the *mutual tontine,* which is organized around the principle of solidarity between members who know each other well. This is a financial association created between people who decide to pool their savings and take turns in accessing the said pool. Each of the members gets the pooled money according to a pre-established order, which can be subject to change. Every member can also lend money or take out a loan. In principle, debts are not subject to interest. A *mutual tontine* is a system that primarily helps members accumulate their own savings on a daily basis, or over a period of one week or one month.[2] Participants generally pay their share according to the time horizon they choose, with higher contributions for longer time horizon (daily contributions are lower than weekly ones, which are, in turn, lower than monthly contributions).[3] The average size of a ***tontine*** is nine participants, of which about 85 percent are women. The membership usually brings together friends (20 percent coworkers), neighbors (40 percent), and coworkers (60 percent). About 20 percent of the existing ***tontines*** are daily, 30 percent weekly, and half of them are monthly. The second form of traditional arrangement is the credit to wage earners (***Bill*** or ***Masrouf***), which is widely used in the capital city. Small loans are extended to participants for fixed fees to pay for their daily expenses. These loans are then reimbursed by participants at the end of the month when they usually receive their salaries. The final financial arrangement is the ***retailer credit***. In this situation, some traders entrust peddlers or retailers, who do not have working balances at their disposal, to sell some goods door-to-door or in their shops. The sale income is then paid to the original traders for a fixed commission.

[1] Source: Djibouti authorities.

[2] *Tontines* are known in virtually all African countries. They are diverse and have different names depending on the country or even regions within the same country: *Esu* or *Adjo* in Benin and Niger, for example. There are three types of *tontines*: the *mutual tontine*, the *financial tontine*, and the *commercial tontine.*

[3] In 1995 the shares paid by participants were estimated at $3 for a daily ***tontine***, $23 for a weekly ***tontine***, and $89 for a monthly ***tontine***.

32. A similar project was launched by *Caritas Internationalis* (CARITAS) between 1996 and 2000. The approach used was similar to the Bangladesh Grameen Bank's.[13] It was based on the voluntary formation of small groups of four people to provide mutual, morally binding

[13] The Grameen Bank provides credit to the poor in rural Bangladesh without any collateral. Its banking system is based on mutual trust, accountability, and participation.

group guarantees in lieu of the collateral required by conventional banks. The project benefited 800 women, who received small loans (on average $600 over a period of one year with a 10 percent interest rate) totaling about $709,000. The project ended in 2000 for similar reasons as the AFD program did. Following the CARITAS approach, a microcredit program was launched by the Social Development Fund (FSD) in 2001. The program was financed by the African Development Bank and promotes income-generating activities by granting microcredits to women. The implementation of the program is entrusted to nongovernmental agencies (NGAs) and financed by the FSD, which also provides support in terms of methodology, training, management, and computerization. The women who participated live in the capital and three other cities (Tadjourah, Obock, and Ali Sabieh). They each received between $170 and $560. The program benefited 800 women, who obtained loans totaling about $113,000.

33. A more recent initiative was the creation in 2001 of the FDD, presumably to replace the Djibouti Development Bank which was liquidated in 1999. The FDD has yet to start operations. Furthermore, in 2002 the International Fund for Agriculture and Development (IFAD) conducted a study on the feasibility of rural microfinance, but this project is still under examination.

34. **The development of microfinance in Djibouti has been hindered by the lack of a regulatory framework, a weak judicial and fiscal environment, resource constraints, and the lack of institutional support.** Presently, microfinance activities remain largely unregulated. However, since the 2000 banking law alludes to adjustments necessary to regulate microfinance activities,[14] it is presumed that the BCD is aware of the need to develop a legal framework for microfinance institutions. The existing legal system is weak and often fails to enforce contractual and property rights. There is a limited knowledge of judiciary rules, only a few justice professionals, and frequent political interference in the functioning of justice. In addition, most microfinance institutions existing in Djibouti are largely subsidized, operate with insufficiently trained staff, and have not yet defined clear development plans. Furthermore, their accounting and management systems are poorly developed. While the government has been paying attention to the microfinance sector for sometime, the initiatives taken so far (e.g., by setting up various working groups) have failed to put in place a framework where the various actors in this sector could exchange views. As a result, there exists a variety of dialogue frameworks that hardly reach an operational stage, presumably due to the absence of a clear understanding of the roles of different structures involved, and the lack of human resources and competencies in this area.

[14] Articles 11 and 16 of the this law indicate that any organization that starts a microfinance program needs to sollicitate an official operation agreement, even if the conditions for its financial viability are not entirely met and/or it is unable to provide reliable data in line with BCD's regulations.

IV. Financial Sector Reforms and Growth Issues

35. To maintain the integrity and effectiveness of the financial system, the authorities took, in the last 12 years, a number of measures covering three main areas, namely the legal framework, supervision and prudential regulations, and financial intermediation. However, these measures were mostly driven by the requirements of donor-supported programs (including programs with the Fund) and were not really part of a comprehensive financial sector reform program. Furthermore, these measure were not very ambitious and their implementation was slower than initially envisaged. As a result, they have had only limited impact so far and additional efforts would need to be made to strengthen the financial system and improve Djibouti's attractiveness as a regional commercial and financial center. These efforts should focus again on the areas mentioned above but also should aim at improving contractual property rights and deepening the financial sector.

A. The Legislative Framework

36. **Revised banking law and central bank statutes were adopted by parliament in June 2000 and replaced previous laws dating back to 1985.** The 2000 banking law introduced four main provisions. First, for a new banking institution to operate, at least 30 percent of its capital should be owned by a sound foreign banking institution (against 20 percent in the 1985 law). Second, each bank should conduct regular internal audits and report the results to the BCD. Third, the annual on-site supervision of each bank by the BCD should be undertaken annually. Fourth, disciplinary actions should be taken against banks' management members in case of misconduct. As a result of this law, report requirements to the BCD by all banking institutions on their activities in detail were also strengthened.[15] However, the new laws contained a number of weaknesses, including inadequate rules for setting up new financial institutions; a failure to specify sanctions for banks not in compliance with banking regulations; and operating rules for the central bank which would permit the extension of commercial and other credits to private, nonfinancial institutions.[16] Legislative amendments to correct these shortcomings were prepared in the context of the PRGF program in 2002. The revised draft laws, which also include institutionalization of the external auditing of the BCD's accounts mechanism, was submitted to the cabinet for approval in late 2002 but are yet to be adopted by the latter and by the national assembly.

37. **In the same vein, the government adopted in September 2002 a new law on money laundering, confiscation, and international cooperation with regard to the proceeds of crime.** This law provides Djibouti with a sound legal framework that should be used to ensure continuous monitoring of the integrity of the financial system. The authorities

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[15] In the past, banks' reporting to the BCD was not done in a systematic manner.

[16] The provision was already in the previous law but never used, and was inadvertently kept in the revised BCD statutes.

are also pursuing their efforts to increase the awareness of financial institutions of money laundering issues, updating the regulatory framework for financial operations, and enhancing the capabilities of the financial investigations unit at the BCD. The next step would be to expedite the adoption of the new revised banking laws to correct existing flaws in the current laws; and implement measures to combat money-laundering and fully comply with the UN resolutions.

B. Supervision and Prudential Regulations

38. **The authorities have made headway in improving the supervisory capabilities of the BCD**, for both off- and on-site supervisory capabilities. This was achieved through personnel training, and with external technical assistance including from Fund resident advisors. In regard to off-site supervision, conducted at least once a year, the Djibouti banking regulations include a comprehensive set of prudential ratios for banks. The requirements for these ratios take into account the country-specific context [17] by being more strict than the general internationally accepted capital adequacy and risk diversification standards. On-site supervision of commercial banks started in 1996 and aims at inspecting each financial institution once a year. However, due to administrative capacity constraints, the BCD was able to supervise on-site only one bank per year so far. The BCD completed, for the first time, controls of all the money changers operating in Djibouti between end-2001 and early-2002, and plan to inspect them in the future once a year. To this end, the BCD started a program to train its staff, including recent recruits, with the support of the *Banque de France*.[18] In addition, a Fund expert visited Djibouti in December 2002 and provided practical assistance and training for on-site supervision. The BCD is also approaching other donors to fund the training program.

39. To improve transparency of the central bank, the monetary authorities have taken steps to regularly audit the annual financial statements of the BCD in accordance with International Standards on Auditing (ISA). In this connection, a new external auditing firm audited the BCD accounts for 1999, 2000, and 2001 in December 2002. The same auditing firm will conduct the audit of the BCD accounts for 2003 and 2004, thus covering a five-year auditing period.

40. **Notwithstanding the progress achieved so far, the authorities are encouraged to pursue efforts aimed at strengthening the banking supervision.** In this connection, the BCD should extend its training program to include various banking issues[19] so as to improve

[17] Namely, a high level of NPLs, Djibouti's role as a regional commercial and financial center, and the preservation of the existing currency board.

[18] This training program began in June 2002 and continued through December 2002.

[19] These include recent developments in the Basle 2 agreement with regard to new prudential standards, new financial products, and various aspects of microfinance.

the capacity of its staff to keep abreast of all developments in the financial system. Money changers should also benefit from training courses organized by the BCD, especially on accounting procedures and standards, and be kept abreast of developments involving their activities, such as changes in financial regulations and implementation of the law on money laundering.

C. Financial Intermediation

41. **Sound financial intermediation for the benefit of all operators remains a central area for further reform.** To better assess some of the risks that banks are facing in their financial intermediation activities, a series of measures were implemented in 1991. A Risk Office (*Centrale des Risques*) was established, which centralized the accounting of about 80 percent of outstanding bank credits above a minimum level (DF 10 million for commercial banks and DF 5 million for the development bank); in addition, the BCD had initiated the establishment of a data base on outstanding checks without cover.[20] A government decree requiring the submission of such information was adopted at the same time. However, these initiatives were limited in scope and could not by themselves encourage the banks to be more active in the domestic market.

42. **In 2001, in an effort to supplement the commercial banks in providing financing to investors, a presidential decree authorized the creation of a development fund** (*Fonds Djiboutien de Développement*, or FDD). This fund is a public enterprise under the supervision of the ministry of finance which is expected to use concessional lines of credit from bilateral, multilateral, and private sources in order to extend credit to small- and medium-sized enterprises, especially in the tourism, fisheries, services (commerce, handicraft, transport) and agriculture sectors. The investment program of the FDD for the period 2003–10, estimated at about $35 million, would be financed by the Djibouti government (5 percent), the domestic private sector (25 percent), and international organizations (70 percent). However, there was a concern about the possible profitability of the fund and the government emphasized the importance of not providing it with guarantees.[21] Furthermore, the FDD is not subject to supervision by the BCD, which could generate similar difficulties to the one that led the BDD to cease its operations in 1996. Similar attempts in other African countries, such as Kenya and Nigeria, which set up development financial institutions to provide long-term loans, have failed mainly due to lack

[20] This ratio increased further subsequent to the reduction in 2001 of the minimum level outstanding bank credits, which was brought to DF 3 million.

[21] The authorities indicated that they intend to take a small equity share of 20–30 percent (as they do in a domestic commercial bank) and would share the profits and losses of the fund in proportion to its capital contribution. Moreover, the government's contribution would be financed entirely with external concessional resources.

of independence of these institutions from government interference, difficulties in selecting the beneficiaries, fraud and mismanagement, and weak supervision.

43. **To broaden financial activities in support of their national poverty reduction strategy, the authorities have also taken initiatives to develop microcredit programs.** These initiatives aim at establishing institutions that grant direct loans, using their own funds and foreign borrowing, to private sector operators, especially to small operators that usually do not have access to bank lending. However, these institutions can only fulfill their mission if an adequate regulatory environment is put in place. It is also important that these institutions be regularly supervised by the BCD in order to establish healthy relationships with the beneficiaries of microcredits.

D. Other Measures and Developments

44. In view of the difficulties faced by the banking system in enforcing loan agreements, reflecting essentially weaknesses in the judicial system, **the BCD established in July 1999 a notification system under which banks are prohibited from lending to defaulting borrowers, whose nonperforming credits exceed a threshold amount and who are in arrears, until their loans are regularized.** However, the steps undertaken to expedite the judicial process for bank recovery of nonperforming bank loans did not progress as envisaged.

45. **Outstanding weaknesses in the enforcement of loan agreements combined with mismanagement hindered the viability of two commercial banks, the Al Baraka Bank and the BDMO, which were placed in liquidation in 1998 and at end-1999, respectively.** The recovery of these banks' debts and the gradual reimbursement of depositors has been somewhat slower than anticipated owing to a number of judicial delays and other constraints. In addition, the authorities experienced difficulties in liquidating assets, mostly in the form of real estate.[22]

46. **The weak legal structure for contractual enforcement and property rights** likely have a significant impact on the behavior of the financial sector.[23] The court system does not seem to enjoy the confidence of the private sector. Judges are perceived as lacking autonomy. Furthermore, the court system is also slow in resolving disputes. A good illustration is the lengthy liquidation of the two banks just mentioned which has yet to be finalized. While some of these problems are due to lack of financial and human resources, others result from

[22] Djibouti's real estate market is depressed, and it is feared that hastening the sales of real estate properties would lead to large capital losses.

[23] Levine (1999) found that various legal determinants were significantly correlated with the indicators of financial development, having expected signs, despite a difference in their significance levels. He concluded that countries with legal and regulatory systems assuring a high protection of creditors tend to have more-developed financial intermediaries.

political interference in the functioning of the judicial system. The authorities rightly recognize the importance of improving the legal system to ensure success to their national poverty reduction strategy, but would need to expeditiously take concrete measures in this direction.

47. **Financial products available in Djibouti are limited and consist mainly of deposits with commercial banks.** Recently, one of the banks launched an initiative to encourage small consumer credits, focusing on credits to employees of employers with a good reputation, such as the port. While it is too soon to draw firm conclusions from this initiative, the bankers find the results encouraging. To ensure greater mobilization of domestic savings, another area of reform would be the development of new financial products. However, the success of such an operation hinges on the establishment of an adequate regulatory framework. Therefore, a well-sequenced work program would first identify a set of products suitable for local customers, and then tailor a regulatory framework. On both aspects of the operation, technical assistance must be sought.

V. Main Conclusions

48. **The Djibouti financial sector has yet to achieve a more effective role in the Djibouti economy and could be further strengthened.** The level of financial intermediation in the economy remains relatively modest. Banking soundness indicators portray a mixed picture, as banks seem to be well capitalized and profitable, while NPLs ratios continue to be high. There are no domestic banks to help extend banking system services beyond the major metropolitan areas and to small- and medium-size enterprises.

49. **To enhance the effectiveness of the financial sector and maintain its integrity, the authorities have made progress in the last 12 years in the implementation of a number of measures covering the legal framework, supervision and prudential regulations, and financial intermediation**. The new AML law, adopted in 2002, provides Djibouti with a sound legal framework that should be used to ensure continuous monitoring of the integrity of the financial system. The revised banking laws, expected to be adopted in 2003, will introduce clearer regulations for the operation and establishment of financial institutions, and enhance transparency by institutionalizing the external auditing of the BCD's accounts mechanism.

50. **However, further measures are needed to help remove bottlenecks to the expansion of credit to the private sector** and to consolidate supervision practices, promote microfinance, facilitate lending to the private sector, and encourage a generation of long-term savings. Such measures could include:

- Putting in place a comprehensive training program for the supervisory staff at the BCD and the other financial institutions, thus reaping the full benefits of new banking laws, which go a long way in ensuring a more efficient supervisory and regulatory environment.

- Adopting a clear public policy related to microfinance, the key role of which is recognized in the PRSP. An expansion of microfinance activities is predicated on further reforms of the regulatory and supervisory framework, while creating an environment conducive to the development of small businesses. In particular, it would be important to (i) streamline entry and exit procedures for institutions performing microfinance activities so as to ensure more regular financing of beneficiaries; (ii) reinforce capacity-building programs for the microfinance institutions and their supervisors; (iii) ensure adequate capitalization of these institutions; and (iv) enhance the financial institutions' law on microfinance activities and the supervision of microfinance institutions, in particular by developing special supervision procedures compatible with these institutions' ability to monitor risks and with the quality of their structure and personnel qualifications. There is also a need to raise the awareness of beneficiaries about the importance of preserving the ability to take risks.

- Strengthening the judicial system to enable the private sector to benefit from the comfortable liquidity position of commercial banks. Presently, the private sector is deemed to have little confidence in the court system. It is important to alleviate the perception that judges lack autonomy and that the court system is slow in resolving disputes. In doing so, the great potential offered by the microfinance sector would be tapped and commercial banks would likely be more forthcoming in providing financing to the private sector.

- Exploring further possibilities of developing new financial products to ensure greater mobilization of domestic savings and address the financing need of small- and medium-sized enterprises (SMEs), while establishing an adequate regulatory framework so as to ensure success of this operation. Financial products available in Djibouti are limited and consist mainly of deposits with commercial banks. In the current context, SMEs lacking solid equity capital are unable to solicit banks for medium- and long-term financing. To finance their capital investments, they apply for short-term credits (cash facilities) that are usually renewable at high interest rates, which is detrimental to their cash flow.

- Maintaining and enhancing the comparative advantage imparted by the CBA by (i) continuing development of operations that have established the good reputation of the Djibouti financial system; (ii) specializing in innovative financial products for which it would have a regional monopoly, or which would be needed by some regional operators; (iii) establishing agreements with regional banking or insurances institutions, particularly in Ethiopia, including becoming a shareholder in these institutions; and (iv) promoting national banking products and services with neighboring countries and with regional economic institutions, such as the Common Market for Eastern and Southern Africa (COMESA).

Recent Monetary Developments

51. **Following a period during which broad money and nominal GDP evolved with similar trends from 1990 to 1996,[24] broad money and nominal output displayed opposite trends from 1997 to 2000.** While GDP was growing moderately during the latter period, broad money declined steadily (Figure I.5). This decline in broad money was most likely the result of the erosion of the fiscal position. The rapid accumulation of budgetary arrears and forced borrowing from public agencies to cover budget deficits during most of the 1990s weighed heavily on the financial situation of private suppliers, public enterprises, and civil servants. Since deposits with commercial banks are the only financial instrument available in Djibouti, the worsening in the financial position of these economic agents led to the decline in broad money as well as a shift from longer to shorter maturity deposits. At the same time, uncertainty about the economic situation and the lack of confidence toward the government appear to have contributed to some capital outflows, as evidenced by the high level of negative errors and omissions in the balance of payments.[25] Furthermore, the composition of deposits changed in favor of foreign currency, the share of which, in broad money, rose from 36 percent in 1994 to almost 50 percent in 1999 (Figures I.8 and I.9). In the absence of other factors, this development appeared to reflect the growing preference for cash vouchers (an instrument denominated in U.S. dollars in bearer form), and some erosion in confidence in the domestic currency.

52. **During the period from 2000 to 02, broad money grew at about 12 percent per year, while credit to the private sector declined sharply.** Combined with a significant increase in deposits, this decline in credit to the private sector led to a sustained increase in net foreign assets of commercial banks. Furthermore, the recent strong growth in broad money did not cause inflationary pressures, as evidenced by a CPI inflation rate that remained close to 1 percent (Figure I.6) and a money velocity (as measured by the ratio of broad money to nominal GDP) that declined by about 7 percent (Figure I.7). These elements could signal a recovery in the liquidity of the economy and appear to be a reversal of trends observed during the second half of the 1990s.

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[24] The only exception was 1992 when GDP increased at about 3 percent, while broad money declined by about 2 percent, reflecting a fall in the net official foreign assets. The ratio of net official foreign assets to the monetary cover decreased to about 130 percent, from about 170 percent at end-1991. The exceptional level of monetary coverage in 1991 is attributable to important transfers from Saudi Arabia to compensate Djibouti for its support to allies during the war to liberate Kuwait from the Iraqi invasion. Most of these transfers were used by the Djibouti authorities to finance the civil war.

[25] Negative errors and omissions (including short-term capital flows) in the balance of payments were estimated at an average 2 percent of GDP a year between 1990 and 2000, with a pick up to about 7 percent of GDP per year from 1996 to 1998.

Figure 5. Nominal GDP and Broad Money, 1984–2002

(Niperian logarithm indices, 1990=ln(100))

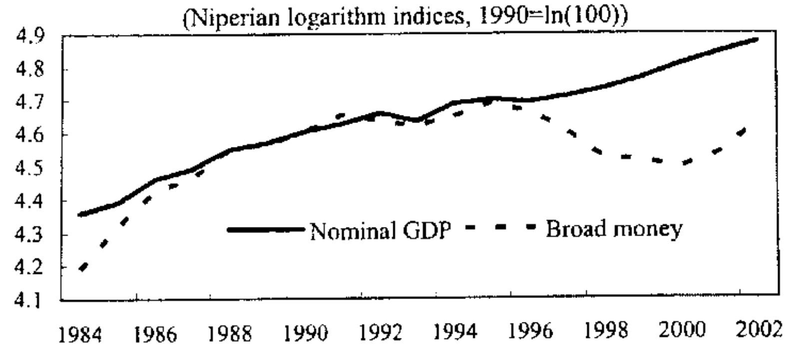


Figure I.6. Inflation and Broad Money

(Annual percent change)

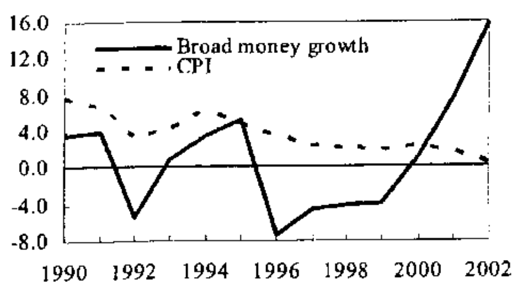
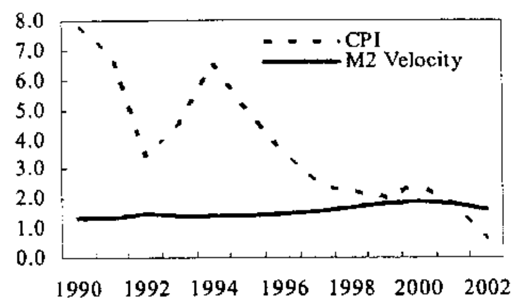


Figure I.7. Inflation and M2 Velocity

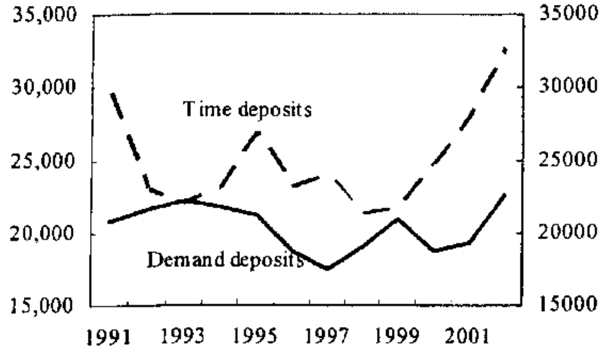
(Annual percent change)



53. **The stabilization and then reversal of the declining trend in broad money started in 2000**, essentially because of the recovery in the economic activity, mostly attributable to the transport sector (subsequent to Ethiopia's decision to channel its transit trade through the port of Djibouti). In addition, with an improvement in fiscal management, the accumulation of budgetary arrears subsided and was halted in mid-2001. This undoubtedly contributed to a rise in deposits and broad money, which grew at a faster pace than nominal GDP. These movements also allow for some catching-up of real money balance toward a level more consistent with the level of economic activity in Djibouti. Furthermore, large (unidentified) capital inflows (part of errors and omissions in the balance of payments) may also have contributed to money growth.

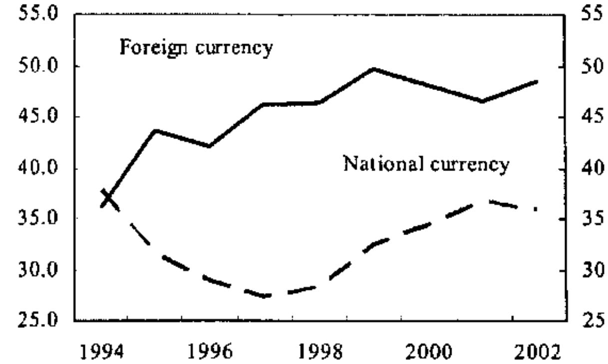
54. **Deposits grew significantly in response to an improvement in the liquidity situation of households and the limited range of available financial products.** Time depoisits contributed to most of the total increase in deposits. In addition, the rising trend in the share of foreign currency deposits was halted after 2000, although its level remains high at 48.5 precent in 2002.

Figure I.8. Demand and Time Deposits, 1991–2002 (In millions of DF)



Source: Djibouti authorities; and IMF staff calculations.

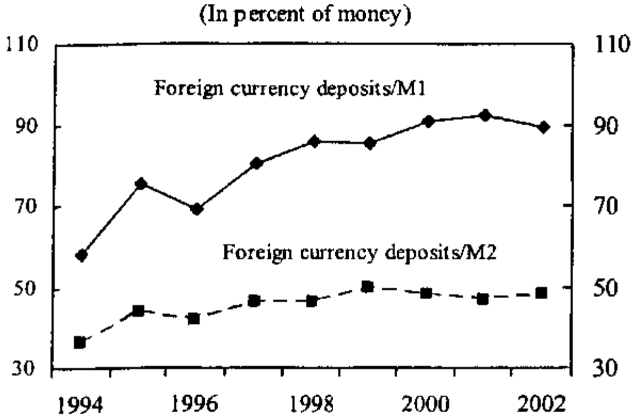
Figure I.9. Currency Composition of Deposits, 1994–2002 (In percent of broad money)



Source: Djibouti authorities; and IMF staff calculations.

55. While foreign currency deposits represent only part of foreign currency holdings in Djibouti,[26] and do not distinguish between domestic residents and foreign holders, its relatively high level leads one to wonder about **the scope of currency substitution**. With a substitution ratio (foreign currency deposits-to-broad money ratio) of about 36 percent in 1995, Djibouti already stood among the highly dollarized economies examined in Baliño et. al. (1999), such as Argentina, Nicaragua, or Croatia. The substitution ratio had been on an increasing trend until 1999 and has remained high since then. Figures I.10 and I.11 depict the trend of currency substitution in Djibouti by using the ratio of foreign currency deposits (FCD) to both M1 (base money) and M2 (broad money). The large gap between the FCD-to-M1 ratio and the FCD-to-M2 ratio reflects the fact that FCD accounts for about half of broad money and, hence, a large part of changes in broad money is explained by

Figure I.10. Djibouti: Foreign Currency Deposits Ratios, 1990-2002 (In percent of money)

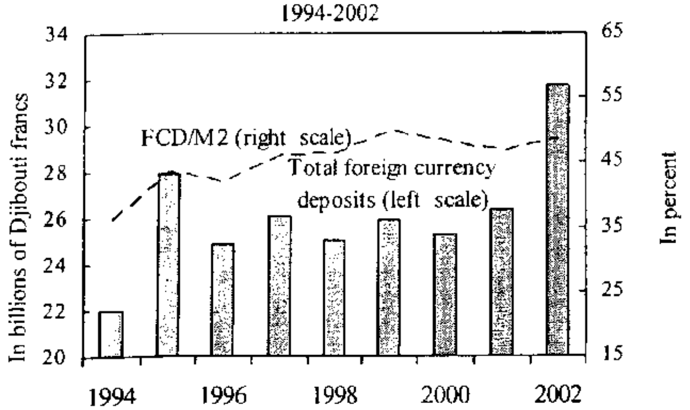


Sources: Djibouti authorities; and IMF staff calculations.

[26] A more comprehensive measure of the stock of foreign currencies held by Djibouti residents conventionally should be viewed in terms of the volume of foreign currencies circulating in Djibouti, foreign currency deposits in the domestic banking system and cross-border deposits held at foreign banks. Since data on the last two components are not available, foreign currency deposits is the only proxy for measuring foreign currency holdings in Djibouti.

changes in FCD.

Figure I.11. Djibouti: Foregn Currency Deposits, 1994-2002

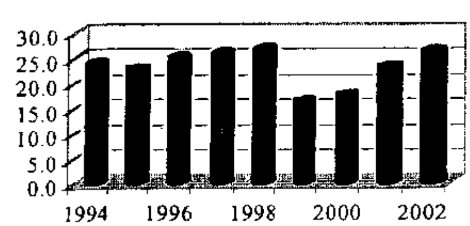


Sources: Djibouti authorities; and IMF staff calculations.

56. Currency substitution may benefit the economy by enhancing reintermediation and promoting financial deepening. However, by inducing a reduction in the real demand for domestic currency, it may involve a loss of *seigniorage*, the profits accruing to the monetary authority from issuing the legal tender. Although these negative impacts may be limited, their growing importance, as shown by the various ratios discussed above, raises some concerns. The evolution of these ratios may suggest that, despite progress achieved through financial sector reforms under the two IMF programs, the fixed exchange rate regime in place, a low level of inflation, and a continued political stability, the Djibouti people are still not fully confident about future developments.

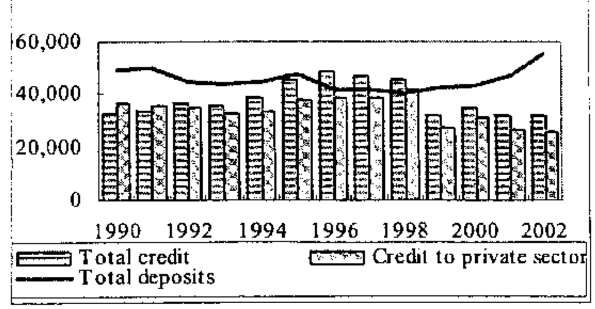
57. **Although commercial banks have a comfortable liquidity position, credit to the private sector has been low and declining since end-2000.** These developments reflect commercial banks' cautious approach in view of a high level of NPLs and weaknesses in the judiciary system that impedes recovery of NPLs, as well as uncertainty about the economic situation (Figures I.12 and I.13). Moreover, a large share of documentary credits (mainly trade credits) was gradually captured by other markets, particularly Dubai, after the Somali border was closed in early 2001, and was not regained after the border reopened later in that year.

Figure I.12. Non Performing Loans, 1994-2002 (In percent of total loans)



Sources: Djibouti authorities; and IMF staff calculations.

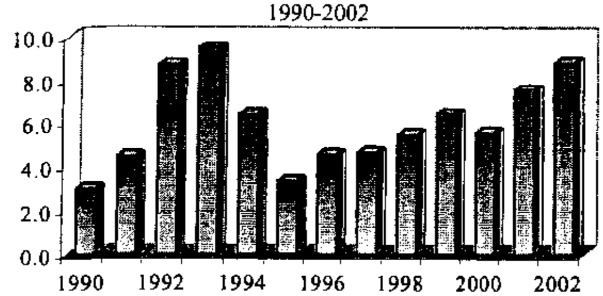
Figure I.13. Deposit and Credit, 1990-2002 (In millions of DF)



Sources: Djibouti authorities; and IMF staff calculations.

58. **On the demand side, high lending rates practiced by commercial banks discouraged the development of credit to the private sector.** The spread between the domestic lending and deposit rates widened sharply from 1995 to 2002 (Figure I.14). On the other hand, the lending rates have been only partially responsive to the decline in international rates. On the other hand, the international rates in the late 1990s was accompanied by a corresponding (but partial) reduction in domestic rates on deposits, consistent with indicators of some increase in the rist premium and commissions changed to commercial banks' customers in Djibouti.

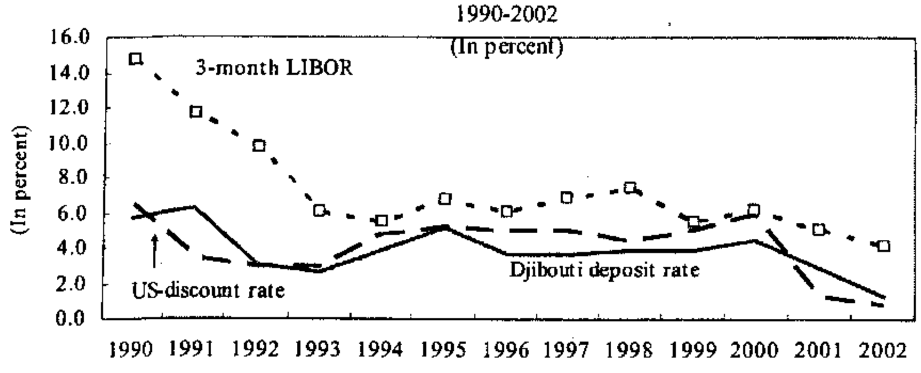
Figure I.14. Djibouti: Interest Rates Spread, 1990-2002



Source: Djibouti authorities; and IMF staff calculations.

59. From 1995 to 2002 the interest rate spread[27] widened by about over 5 percentage points, from 3.4 **percent** in 1995 to 8.8 percent in 2002. This is consistent with banks' increasing provisioning for NPLs. This may also reflect a declining competition among banks, as evidenced by the further increase in the spread starting in 1999 when the number of operating banks declined from five to three. On the other hand, the fall in the international rates in the late 1990s and early 2000s was accompanied by a corresponding (but partial) reduction in domestic rates on deposits, consistent with indications of some increase in the risk premium and commissions charged to commercial banks' customers in Djibouti (Figure I.15).

Figure I.15. Djibouti. Domestic and Foreign Interest Rates, 1990-2002



Source: Djibouti authorities; and IMF staff calculations.

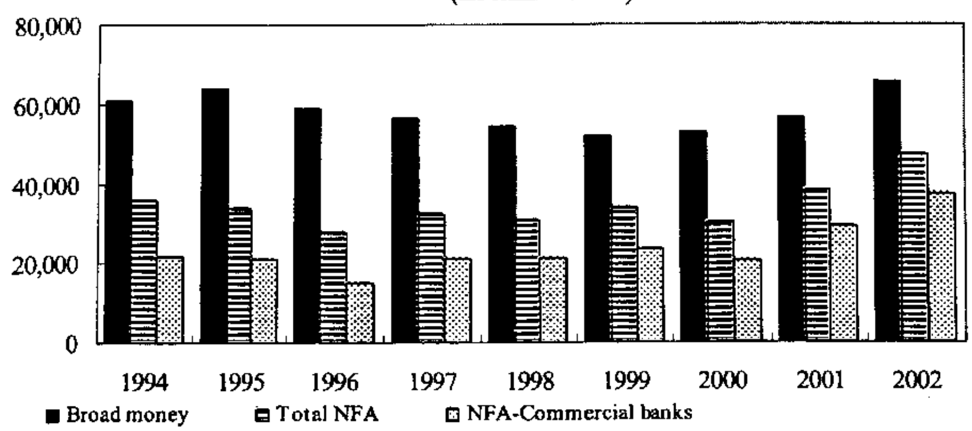
60. Aware of the need for a more active credit policy favoring productive activities, and concerned about collusion among banks in setting interest rates, the authorities introduced in August 1999 at the initiative of the

[27] The interest rates spread is measured by the difference between the minimum lending rate and the maximum deposit rate.

bankers' association corrective measures to preserve a competitive financial market. These included several instructions to banks to cease coordination of interest rate structures and to publicize and report their structures to the BCD. Parallel instructions were issued regarding bank fee structures which also were subject to collusion. However, the effectiveness of the these measures was limited by the official stance of BCD not interfering with the freedom of the commercial banks to determine credit policy.

61. As a result of opposite developments in deposits and credits, **commercial banks accumulated large amounts of net foreign assets** (Figure I.16), which increased by about US$50 million in 2001 and a further US$45 million in 2002 (a cumulative 7.6 percent of GDP, or 8.6 months of imports of goods and services). The coverage ratio of the currency board, as measured by the ratio of gross foreign assets of the BCD over the monetary base and government deposits at the BCD, has been slightly fluctuating around 115 percent since end-2000.

Figure I.16. Broad Money and Net Foreign Assets, 1994-2002
(In millions DF)



Sources: Djibouti authorities; and IMF staff calculations.

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CHAPTER II. FISCAL ADJUSTMENT—ASSESSMENT AND OUTLOOK*

I. INTRODUCTION

1. During the first half of the 1990s, Djibouti's economic and financial situation deteriorated sharply for several reasons including (i) the persistent economic sluggishness, dating back to 1984 after the real estate boom ended; (ii) the outbreak, in early 1992, of an ethnic armed conflict; (iii) the curtailment of the commercial transactions with Ethiopia; (iv) the closure of the border with Somalia; (v) the uncertainties generated by the middle east conflict of 1991; and (vi) a lack of fiscal discipline. Reflecting these adverse developments, the fiscal deficit, on a payment-order basis (including grants), widened significantly, large domestic budgetary arrears were accumulated, the real effective exchange rate (REER) appreciated, reserves fell, and economic growth declined. These developments were inconsistent with the currency board arrangement (CBA) that has been in place in Djibouti since 1949.[28]

2. Given the CBA in place, and the ensuing lack of monetary and exchange rate instruments, fiscal adjustment and fiscal reforms were absolutely necessary to correct the economic and financial imbalances and have, therefore, been the main focus of the authorities since 1994. From 1994 to 2002, the authorities managed to reduce the fiscal deficit on a payment-order basis by about 10 percentage points of GDP, a significant effort that has few parallels in recent history.[29] To achieve this impressive adjustment, they relied primarily on expenditure restraint. In addition, tax reforms rationalized and simplified the tax system and eliminated some critical distortions, and expenditure management reforms helped improve prioritization and control of public spending and transparency of public finances.

3. Fiscal adjustment appears to have had a negative impact on economic growth in the mid-1990s, although it was offset to some extent by higher domestic demand. In addition, despite progress toward fiscal sustainability, which is usually believed to promote economic growth, Djibouti's growth performance has remained modest. This is because structural rigidities remain and have constrained potential gains in productivitiy. As a result, the cost of production factors in Djibouti still is very high, and the economy's external competitiveness was further eroded throughout the 1990s. A key challenge for the authorities will be to design and implement policies that could bring the Djibouti economy on the path of higher and sustainalbe growth to reduce poverty and provide jobs to the unemployed.

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* Prepared by Abdelrahmi Bessaha (MCD).

[28] Chapter II on the financial system in Djibouti discusses, in more detail, issues related to the CBA.

[29] During the same period, the domestic budgetary balance—defined as the difference between domestic revenue excluding grants and domestically-financed current and capital expenditures—improved by the same magnitude.

4. Another issue raised by Djibouti's experience is how the authorities managed to maintain the currency board arrangement despite the large fiscal imbalances that emerged in the early 1990s. It appears that confidence in the system was weakened only temporarily, and continued to be supported by full free trade and capital flows, as well as access to external financing by subsidiaries of foreign banks operating in Djibouti.

5. This paper is organized as follows. The second section presents some stylized facts on fiscal developments and the various fiscal reforms introduced between 1994 and 2002 to correct the imbalances that emerged during the early 1990s. The third section reviews macroeconomic developments during the fiscal adjustment process, and briefly discusses the resiliency of the CBA in the face of large financial imbalances. The fourth section examines the need for further fiscal consolidation in the future. It then concludes by assessing the sustainability of the medium-term fiscal position in light of the government's spending plans to address poverty issues.

II. Fiscal Adjustment in Djibouti: Stylized Facts

6. **Since 1994, two periods of fiscal adjustment (1994–96 and 1996–2002) can be distinguished.**[30] These two periods differ as follows:

- The government initiated the first phase of fiscal adjustment without external support and under extreme liquidity constraints. In contrast, the fiscal adjustment in the period from 1996 to 2002 was supported by the donor community, including the Fund in the context of the stand-by arrangement (SBA) from 1996 to 1999 and an arrangement under the Poverty Reduction and Growth Facility (PRGF) from 1999 to 2002.

- The first phase of fiscal adjustment was much more pronounced, with a sharper reduction of the fiscal deficit. It was driven mainly by cuts in spending, including the wage bill, expenditure in goods and services, and domestically financed capital outlays. The particular emphasis on reducing expenditures was due to the already high level of revenue. In contrast, fiscal adjustment during the second phase was more limited, partly because the gains made in the earlier phase were not fully consolidated. Expenditure cuttings in the wage bill were offset by a fall in the share of revenue to GDP, brought about by a shrinking tax base under the weight of tax exemptions. At the same time, some progress was achieved toward improving the tax system and expenditure management, although implementation of reforms was often delayed (Table II.1).

- Although the cost-cutting policy actions exceeded the budgeted target, they were not enough to offset the much lower-than-envisaged yield of revenue-raising measures; as a result, the deficit could not be brought in line with available financing and new domestic and external arrears were accumulated during the period.

[30] A detailed review of fiscal developments during the fiscal adjustment period is provided in Annex I.

Table II.1. Djibouti: Fiscal Measures and Outcomes, 1994–2002

(Changes in percentage of GDP)

	First phase 1994–95		Second phase 1996–2002	
	Expected yield of budgetary measures	Actual change	Expected yield of budgetary measures	Actual change
Revenue (increase)	5.2	0.4	3	-5.3
Spending (reduction)	-4.8	-5.3	-5	-10
Total reduction of deficit (- =reduction)	**-10**	**-5.7**	**-8**	**-4.7**

Sources: Djibouti authorities; and Fund staff estimates.

A. Revenue Contribution to Fiscal Adjustment

7. **Revenue growth has not contributed to the fiscal adjustment that has taken place since 1994.** While the revenue to GDP ratio made a marginal contribution during the first phase of adjustment, it fell significantly (by almost 5 percentage points) during the second phase of adjustment.

- This negative development may reflect greater reliance by the authorities on tax exemptions to attract private investment (Table II.2), distortions of the tax base brought about by frequent annual discretionary tax measures to offset slippages in spending, and a delayed introduction of much needed reform on the tax side.

- The main policy effort on the direct revenue side was the introduction, by 2001, of a self-assessment system and the unification of taxation on work-related incomes as part of a set of measures aimed at rehauling the direct tax system. This raised the share of direct tax to GDP by about 1 percentage point to 9.4 percent of GDP from 1994 to 2002.

- Indirect taxation declined during that period by 7 percentage points to 11.7 percentage points of GDP, as revenue from the domestic consumption tax and other surtaxes steadily fell on account of the unfavorable economic environment, regional instability which fueled tax fraud and smuggling from neighboring countries, and a weak tax administration.

- By and large, most fiscal reforms were introduced relatively late in the adjustment process, and aimed at rationalizing and simplifying the tax system and addressing distortions in the taxation of income, brought about by frequent changes in the structure measures.

Table II.2. Djibouti: Value of Tax Exempt Goods and Services, 1998–2002

(In billions of Djibouti Francs; unless otherwise indicated)

Preferential regime	1998	1999	2000	2001	2002
Vienna Convention (diplomatic privileges)	0.8	0.8	1.1	1.4	1.0
Public contracts	3.2	2.0	2.2	1.1	3.2
Private investment	1.5	1.2	5.2	1.0	1.2
Free trade zone	...	...	...	...	...
French army	26.3	33.9	21.6	27.1	31.8
Others	2.6	2.9	1.6	3.2	5.2
Grants	1.1	1.0	0.6	0.7	0.4
National army of Djibouti	0.2	0.8	0.2	0.4	1.0
Tax code	0.6	1.0	0.6	1.5	1.6
Presidential privileges	0.7	0.2	0.2	0.6	0.5
U.S. army	0.0	0.0	0.0	0.0	1.0
Spanish army	0.0	0.0	0.0	0.0	0.7
Total	34.4	40.7	31.7	33.8	42.4
Excluding French army	8.1	6.8	10.1	6.7	10.6
Memorandum items:					
Nominal GDP	91.2	95.3	98.2	101.9	105.2
Total revenue	23.2	22.4	24.0	23.7	24.9
Total imports	58.1	58.2	62.5	58.8	63.9
Total revenue / total exemptions ratio (in percent)	0.67	0.55	0.76	0.70	0.59
Total imports / total exemptions ratio (in percent)	1.69	1.43	1.97	1.74	1.51
Exemptions / total nominal GDP ratio (in percent)	0.38	0.43	0.32	0.33	0.40

Sources: Djibouti authorities; and Fund staff estimates.

B. Expenditure Contribution to Fiscal Adjustment

8. **The fiscal adjustment was essentially achieved through spending cuts in categories that contributed to the earlier upward trend in the expenditure ratio, such as wages and expenditure in goods and services.**

- A reduction in the wage bill contributed significantly to fiscal adjustment in the latest period, largely due to military demobilization (Box II.1) and civil service retirement programs, as well as a freeze on the hiring of government employees in nonpriority sectors. As a result, the wage bill declined by about 10 percentage points of GDP between 1994 and 2002.

- Expenditures on goods and services, expressed as a share of GDP, reached a peak of 11.5 percent of GDP in 1993; they were then halved between 1994 and 2002. This marked reduction reflects better spending targeting, improved prioritization, and expenditure rationalization.

- Domestically financed public investment declined as a percentage of GDP and was accompanied by a decline in foreign project financing. The decline reflects weak internal coordination and resource constraints.

- Expenditure restraint was well underway when major reforms in public expenditure management, including procedures to improve expenditure management and control, were introduced between 2001 and 2002. The latter reform will be critical in efforts to improve the quality and efficiency of public expenditures.

C. Budgetary Reforms

9. **Budgetary reforms were crucial in bringing about financial stabilization and contributing to sustainable fiscal policies over the medium term.** The reforms, whose momentum picked up in the late 1990s and from 2000 to 2002, focused on maintaining the current high levels of revenue mobilization, strengthening the budget process, and reexamining spending priorities.[31]

Tax Reforms

10. By the end of the 1990s, Djibouti's tax system, which was drafted in 1974, three years before the country gained independence in 1977, had become complex and highly distorted as a result of changes made on an ad hoc basis for fiscal consolidation purposes or simply to meet demands from particular interest groups. The first of these changes occurred in 1994 when the investment code was amended twice, the first time in October when the authorities granted substantial and generous exemptions to investors, and the second time in December when the same privileges were extended to exporters operating in a newly created industrial free-trade zone. The second round of changes took place in 1996, with the inclusion of benefits in kind in the tax net. In 1997, the business lump-sum tax was modified; and a year later, the marginal rates on property taxes were changed. In 1999, the property tax was again reformed to benefit resident owners, and the base was extended to include benefits in kind and rental properties.

[31] During the 1990s and from 2000 to 2001, government resources were allocated mainly to wages and salaries and other non-interest outlays, leaving little room for capital spending.

Box II.1: Military Demobilization [1/]

The incorporation of a significantly large contingent of new recruits in the ranks of the regular army in the early months of the 1992 conflict placed a heavy burden on the fiscal accounts of Djibouti. **The authorities quickly realized that strong action needed to be taken.** By 1993, using their own resources, they launched a demobilization process which ultimately led to the dismissal of 3,943 soldiers by end-1996. While this first wave of departures somewhat alleviated the pressure on the budget, additional efforts were needed in this area.

The second phase of the demobilization program was launched at the time of the Geneva Conference, organized in May 1997, with support from France and the European Union. The program was expected to be completed by end-1998, and aimed at demobilizing 8,720 people (3,275 from the national police forces and 5,445 from the army). However, by December 1998, only 4,151 staff were demobilized. The program was relatively easy to implement at the outset, since personnel volunteered to leave the army and police. However, subsequent departures were more difficult to organize for various reasons, including the fact that the severance benefits were modest for those who had been enrolled in the security forces for a long time. Senior officers were also reluctant to let their troops leave in the face of protracted peace discussions, which were eventually concluded in May 2001.

By end-2002, 4,737 personnel were demobilized with external support, for an estimated cost of DF 1.6 billion as part of the second phase; the first foreign-financed wave of demobilization by France took place in 1997 and helped demobilize 2,785 persons for an estimated cost of DF 0.95 billion; the second wave was financed by the European Union and included 1,752 persons for an estimated cost of DF 0.619 billion. The savings from these two waves of demobilization are estimated at DF 0.950 billion and DF 0.630 billion, respectively. The European Union also financed the demobilization of 1,274 security personnel from the armed opposition, the *Front pour la Restauration de l'Unité et la Démocratie* (FRUD). Their demobilization did not entail any budgetary savings but contributed to the consolidation of the peace agreement. The number of government military personnel that remain to be demobilized is 3,983; their wage bill amounts to DF 1.6 billion (1.3 percent of GDP) and remains a major burden for the public finances.

Overall, performance under this program was mixed. It was instrumental in cutting the number of security personnel (by almost 50 percent between 1997 and 2002) who were targeted for demobilization; however, this result was achieved over a much longer period (five years) than initially envisaged (two years). While it is felt that the initial deadline was too ambitious, nonetheless the authorities could have demobilized more personnel during the period between 1997 and 2002.

[1/] In parallel to the demobilization program, the authorities set up a reinsertion program with donor support. A reinsertion project was adopted by the World Bank in June 1998. However, this project was under funded ($2.73 million), weakened by administrative constraints, and poorly coordinated with the reinsertion component funded by the African Development Bank. As a result, the project was abandoned in June 2001.

11. **The tax system was simplified and improved by the comprehensive reform implemented in 1999 and 2001 in the context of the PRGF-supported program, in an effort to build a more coherent and buoyant tax system.** These reforms covered both indirect and direct taxation.

12. **As far as indirect taxation is concerned, the key element relates to the reform of the consumption tax.**[32] Several changes were introduced in 1999, including (i) the replacement of the preexisting schedule of seven rates (which comprised a number of specific taxes) with a simplified structure of three ad valorem rates of 8 percent, 20 percent, and 33 percent; (ii) the elimination of ad hoc exemptions to the consumption tax, thus limiting them only to domestic and foreign security forces, relief organizations, activities exempted under the investment code, and the railroad partnership with Ethiopia; (iii) the extension of the domestic consumption tax to all goods produced domestically. In addition, Djibouti reformed the petroleum tax and its administration in 1999,[33] and eliminated the excise taxes on mineral water, milk and dairy products, and wheat flour, as well as the export taxes on livestock.

13. **Direct taxation was targeted for sweeping changes. The first wave of measures was introduced by mid-2001.** The authorities opted to maintain the schedular tax system. Taxes are now collected on work-related incomes, industrial and commercial profits, and profits from noncommercial professionals. The idea behind the grouping in each schedule is to simplify tax procedures and eliminate redundancies in the administration of taxes sharing the same base and targeting the same taxpayer. Taxation on work-related incomes now covers all incomes earned by individuals in Djibouti, including salaries, fringe benefits, pensions, all benefits in kind, and the patriotic tax. The unified tax is now called tax on wages and salaries.[34]

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[32] The consumption tax (*taxe intérieure à la consommation*) has been a substitute for import duties because virtually all goods consumed in Djibouti are imported. This tax is not really a general domestic consumption tax. Its base has remained narrow because it has excluded taxing services such as electricity, telecommunications, hotels, insurance, as well as port-related activities. Until 1999, domestically produced goods were also exempt.

[33] The objective was to generate increased revenue, simplify the oil tax structure, and reduce price distortions. To that end, excise taxes for diesel and aviation fuel, which accounted for 40 percent of oil products consumption at the time, were raised while the excise tax on kerosene—a product used for cooking by lower-income groups—was eliminated for environmental and social reasons. The increase in the aviation fuel tax that was agreed under the PRGF program proved counter-productive, as consumption of aviation fuel in Djibouti fell dramatically following this tax change.

[34] The new tax brackets are 2 percent (DF 0–DF30,000); 15 percent (DF 30,000–DF 50,000); 18 percent (DF 50,000–DF 150,000); 20 percent (DF 150,000–DF 600,000), and 30 percent (over DF 600,000).

14. Other key measures include (i) revision and expansion of sanctions and legal liabilities for delinquent taxpayers to include a wide range of sanctions and liabilities, from the exclusion from public procurement to the publication of the list of delinquent taxpayers; (ii) creation of a unit in charge of large taxpayers (LTU), together with a unified taxpayer identification number (TIN). At the same time, all procedures related to setting up a TIN were overhauled, (iii) introduction of a new self–assessment tax system to allow prompt payment of direct taxes by taxpayers with limited intervention from the tax administration; (iv) strengthening of tax control and audit programs;[35] and (v) establishment, in collaboration with the chamber of commerce, of licensed tax centers to help all firms adopt accounting rules and participate in the fiscal net.

15. A second range of measures is expected to be introduced in the coming months with a view to reform taxation on profits generated by industrial and commercial operators. These measures will include the following: (i) a new system of tax reporting that would unify all taxes on industrial and commercial profits, like the BIC (*Bénéfices Industriels et Commerciaux*), BNC (*Bénéfices des Professions Non Commerciales*), and IPM (*Impôt sur les Bénéfices des Personnes Morales*). The new tax will be called Tax on Professional Profits (TPP); (ii) a revamped business tax (with a simplified structure); and (iii) the unification and simplification of the tax exemptions and the inclusion of the remaining tax privileges (currently in the investement code) in the tax code.

Expenditure management reforms

16. The serious budgetary difficulties encountered by the Djibouti authorities during the 1990s exacerbated the weaknesses of public expenditure management, which was characterized by (i) a lack of consolidated framework for presentation and execution of spending, (ii) an inadequate legal environment, (iii) an absence of a macroeconomic framework exercise under which budget preparation and execution could be carried out; and (iv) cumbersome overall expenditure procedures.

17. **Throughout the 1990s, in the absence of a consolidated framework, budget presentation and execution were seriously flawed.** The budget presentation was made on a piecemeal approach, essentially based on the source of financing. Nomenclatures used to report revenue and expenditure transactions were outdated and could not be computerized. These weaknesses hampered the analysis of operations and the introduction of corrective actions. In addition, budget preparation was conducted mainly toward the end of the year,

[35] To strengthen tax control and audits, the authorities created a tax auditing structure intended to ensure better collection and coverage of the full range of taxes as well as a general verification unit backed by two specialized control and investigation units. They also reorganized the unit in charge of the business tax, issued the TIN using data and information contained in the roster of property owners, and undertook the full computerization of all tax declarations.

making it difficult for the financial authorities to take important trade-off decisions at the various levels of government. At the same time, capital spending was prepared and executed outside the government finance system, with little coordination between staff involved in budget preparation and planning. Budget execution was also hindered by resource constraints, the extensive use of the procedure of advance payment of government orders (or execution of such orders prior to commitment), and the circumventing of spending regulations by the National Assembly and the Constitutional Council. These weaknesses contributed to the accumulation of domestic payment arrears.

18. **The legal framework governing expenditure management,** was also totally inadequate. It was based mainly on texts adopted in 1968, at the time of the French Territory of Afars and Issas (financial regulations and regulations governing public accounting), and on the 1992 constitution. The coexistence of such disparate legal sources led to a number of inconsistencies, including the required date for filing the draft budget law, the relevant authority that could decide the assessment base, rates, and modalities for collection for all types of taxes, and the supplementary budget period.

19. **A third major shortcoming in the government financial management was the absence of a macroeconomic framework to serve as a basis for budget preparation.** A budget circular—which may contain at times maximum percentage increases from prior year or freezes on some particular outlays—was usually issued rather late in the year (October instead of July) and merely requested officials of various ministries to express their spending projections. Moreover, there was no consultation among the various units in charge of planning and budget preparation, nor any medium-term expenditure framework. The authorities resorted to Fund review missions to design and implement a medium-term expenditure framework, and started their budget preparation late in the year.

20. **Finally, procedures for general spending were complex, slow, costly, and cumbersome.** This was the result of overlapping tasks between the authorizing authority and the ministry of finance, and redundant controls within the ministry of finance. The excessive controls have not prevented excess spending, and have in fact facilitated the circumvention of regulations during times of tight resource constraints, as they represented incentives for incessant recourse to advance funds and spending operations without prior approval.

21. **To address these various weaknesses, expenditure management reforms were implemented,** with a view to (i) strengthen budget execution procedures; (ii) update the budgetary and treasury nomenclatures; (iv) improve debt management; (v) reorganize the ministry of finance to provide an institutional foundation for adequate budget preparation and execution; and (vi) reform the legal framework governing public spending.

Box II.2. Pension System Reform

Djibouti adopted a major reform to the pension system in January 2002 to restore its financial sustainability, improve management efficiency, and set the path for expanding coverage. The reform, as framed in the overall adjustment program of the government, is designed to contribute to restoring fiscal discipline, and strengthen social protection.

Status before the reform
As in many other countries, the pension funds in Djibouti operated on a pay-as-you-go (PAYG) basis, meaning that the current workforce essentially pays for the benefits of the older retirees. The system was set up before independence according to the French PAYG model. It comprised three pension funds: (i) the *Caisse Nationale des Retraites* (CNR), which covers civil servants, police, cabinet members, parliamentarians, and war veterans; (ii) the *Organisme de Protection Sociale* (OPS), which covers private sector workers, non-regular civil servants, and public enterprises workers; and (iii) the *Caisse Militaire des Retraites* (CMR), which provides pensions for the benefit of military personnel.

Various problems put heavy pressures on the entire pension system, leading to the depletion of its reserves, and expenditures in pensions exceeding revenue. These included (i) the generous structure of contributions and benefits; (ii) the deterioration of the economic and financial situation of the country; and (iii) delays in payments of government and private sector contributions. At the same time, the institutional and management capacity of all pension funds was weak. Furthermore, they lacked a database with basic information about contributors and retirees, as well as human expertise to conduct actuarial studies and financial planning. Above all, these pension funds had to face constant government interference, hampering the management of reserves.

Reforms implemented
Following a comprehensive review with the collaboration and assistance of the World Bank, in 2002 the authorities introduced a range of corrective measures covering the parametric, institutional, and financial aspects of the pension system.
On the parametric side, the changes were made to the following: (i) the vesting period which was unified and now covers 25 years of contribution to be eligible for a full retirement pension; (ii) the minimum age for retirement for everyone stands at 55 years; (iii) the calculation mode of future pensions was created now using an average of the salaries earned over the 10 years preceeding the year of retirement, compounded by a percentage of all the contributions; (iv) the rules affecting cumulative pensions (civil servants, parliamentarians, and cabinet ministers): the cumulative amount a retiree can earn is now the sum of the highest pension and 50 percent of the lower one. Furthermore, a minimal yearly pension has been introduced and set at DF 170,000 ($ 1,000), excluding all withholdings and other benefits. Finally, pensions are now taxed at 15 percent.

To address institutional weaknesses and bolster management capacity of the pension system as a whole, the pension funds are expected to merge into one single institution called the *Centre National de Sécurité Sociale* (CNSS) which was created in November 2002. The merger is expected to take place over the next few years.

To clear the outstanding stock of government arrears to the pension funds, financing was secured from the World Bank in the context of the Fiscal Consolidation Credit (FCC). At the same time, the government resumed its regular transfers to pension funds.

Next steps
The next challenges facing the government in ensuring the success of this ambitious reform is to (i) complete the merger of all the pension funds into the CNSS and help make this new institution operational; (ii) build a comprehensive and reliable database of the retirees and contributors; (iii) put in place a system to manage efficiently the reserves of the pension system; and (iv) expand coverage.

22. **Key expenditure reforms were, in particular, launched in November 2001,** when the government adopted a number of legislations simplifying and improving public expenditure procedures, including (i) new budget and accounting nomenclatures, featuring functional and economic classifications; (ii) new nomenclature for accounting documentation as well as a new accounting plan to ensure consistency on procedures; (iii) revised general expenditure procedures intended to eliminate redundant tasks and controls, ensure that line ministries are involved in managing their budget appropriations, and strengthen budgetary execution and control by the ministry of finance; and (iv) new procedures related to special spending operations.[36] At the same time, to ensure that all government financial operations are fully integrated, all special accounts must now be attached to the central budget. The central structures of the ministry of economy and finance were also reorganized to fully restore the budget preparation functions, phase out redundancies in the area of budgetary control, and separate the function of investment program execution from the economic analysis function that were previously performed by the same directorate. Finally, Djibouti introduced new provisions for the allocation of shared expenses, as well as expenditure authorizations by the spending ministry.

23. Furthermore, as part of their efforts to restore public finances, **the authorities introduced an ambitious pension funds reform in early 2002 (Box II.2).** The reform aimed at adapting the pension funds to the new demographic realities of Djibouti, providing benefits in line with the financial capacity of the pension institutions, lowering the wage bill by unfreezing retirement of civil servants, and expanding pension coverage.

III. Macroeconomic Impact of the Fiscal Adjustment

A. Background

24. The traditional view holds that fiscal contractions could lead to deep and lengthy recessions. Cutbacks in government expenditures depress aggregate demand; and a fall in household income, brought about by reduced transfer payments and higher taxes, is associated with a decline in consumption. It is also argued that expectations of permanently lower future paths of government expenditure and taxation could provide a powerful stimulus to consumption because of the anticipated rise in permanent (disposable) income, reflecting the discrete fall in the present discounted value of future taxes. This, in turn, could largely offset the negative impact of a fiscal contraction in the short run and lead to a net increase in aggregate demand and output in the medium term. However, the extent of wage and price rigidities and other costs of adjustment determine how long the adverse output and employment effects of a fiscal contraction will last.

[36] Those carried through imprest accounts or by districts and embassies, as well as expenditures financed with external resources, and outlays without prior approval (external debt service transactions).

25. Evidence on the interplay between fiscal policies and macroeconomic performance suggests that there are no common characteristics among the fiscal episodes experienced by various countries. Fiscal consolidations are not necessarily associated with recessions. In some cases, fiscal contraction led to expectations of higher future disposable income and thus to a boom in private consumption; this in turn helped reverse the initial decline in aggregate demand triggered by the restrictive fiscal policy stance. Another finding is that reliance on spending cuts might have more positive effects on the economy in the medium term than fiscal consolidations that rely on tax increases. Recent research has highlighted that there are some medium- to long-term dangers stemming from the potential supply-side effects of tight fiscal policy. There is a positive relationship that exists between government expenditure on infrastructure (the public capital stock) and productivity in the private sector. When the public capital stock is allowed to deplete, through a lack of new expenditure, an eventual loss of output and upward pressure on prices could be expected. Empirical evidence also suggests that government expenditures are an input into private production. Cutbacks to government expenditures may have a negative impact on the productivity of the private sector and affect long-term economic growth as well as prospects for keeping inflation low.

B. The Djibouti Experience

Overall macroeconomic performance

26. **The authorities were fully aware that, in the short term, fiscal adjustment would weaken the economy, while laying, at the same time, the foundation for improved medium- and long-term growth prospects.**

- Growth performance was mixed. As expected, real GDP continued to decline, on average, by 2 percent per year between 1994 and 1997 (Table II.3) and the gap between actual and potential output widened. By 1998, however, economic growth resumed and reached, on average, 1.5 percent, a level, nevertheless, too weak to have an effect on the rising unemployment and poverty levels.

- Economic growth resulted from several factors, including the decision by Ethiopia to channel all its transit trade through the port of Djibouti following the war with Eritrea; important

Table II.3 Djibouti: Actual and Trend GDP, 1980–2002

(In billions of Djibouti francs at 1990 constant prices)

	Actual real GDP	Potential GDP using Hodrick-Prescott filter	Deviation (Actual GDP-Potential GDP)
1980	72.99	75.53	-2.54
1981	75.11	75.97	-0.86
1982	76.38	76.38	0.00
1983	77.32	76.73	0.59
1984	77.76	76.99	0.77
1985	77.60	77.13	0.48
1986	76.68	77.12	-0.44
1987	77.06	76.96	0.10
1988	77.98	76.62	1.37
1989	75.96	76.08	-0.12
1990	80.39	75.34	5.05
1991	76.95	74.39	2.56
1992	76.96	73.28	3.68
1993	71.84	72.07	-0.23
1994	71.16	70.87	0.29
1995	68.68	69.79	-1.11
1996	65.85	68.93	-3.08
1997	65.36	68.39	-3.03
1998	65.42	68.23	-2.81
1999	66.85	68.50	-1.65
2000	67.33	69.18	-1.85
2001	68.61	70.28	-1.67
2002	70.37	71.77	-1.39

Source: Fund staff calculations.

investments by public enterprises in the water, electricity, and telecommunication sectors; and the presence of foreign troops on peacekeeping missions or in the context of the fight against international terrorism.

- As indicated before, fiscal adjustment contained the growth of public spending through a reduction of the public sector wage bill and other measures to limit expenditures.The decline in government consumption was however offset to a certain extent by a rise in private consumption. This may reflect the efforts by the authorities to ensure regular payments of salaries, the curbing in the trend of domestic arrears and also possible expectations of steady and higher permanent income stemming from the rationalization, simplification, and reform of direct taxation.

- A decline in government investment was triggered by a decrease in external project support and accompanied by a fall in private investment (albeit by a lower magnitude). These developments had most certainly a negative impact on overall productivity and will bear on medium- to long-term economic growth prospects.

- Private savings fell sharply by 8 percentage points of GDP during 1993–96. They improved gradually during the second phase of adjustment and consolidation but remained 2.5 percentage points below the 1993 level.

- Despite progress toward fiscal sustainability, which is usualy believed to promote economic growth, gorwth performance in Djibouti has remained modest in the last few years. This may reflect several factors, including the lack of visibility about the government's long-term strategy, the remaining high level of domestic payment arrears (Box II.3), the slow progress in implementing growth promoting structural reforms; and, more generally and importantly, rigidities in the labor market and a much deteriorated external competitiveness.

Impact on the Currency Board Arrangement

27. Given that fiscal discipline is one of the most important conditions for a successful CBA, it may come as a surprise that the CBA in Djibouti survived to the very large fiscal imbalances during the early 1990s.The large fiscal deficits recorded after the domestic ethnic conflict started were financed, to a large, extent through (somewhat forced) domestic financing from banks and public agencies (including public enterprises and pension funds). As fiscal deficits remained large and the government could not repay its domestic borowing from previous years, large domestic arrrears started to be accumulated toward the mid-1990s, including wages. As a result, the liquidity in the economy was reduced and broad money declined. Signs then began to emerge that the confidence in the domestic currency and the currency board was fragile, as evidenced by large capital outflows (recorded in the balance of payments in errors and omissions) and a shift in the composition of deposits toward foreign currency deposits from 1994 to 1997. In addition, the domestic commercial banks that were not subsidiaries of large foreign banks and had limited access to external financing, ran into difficulties that led to their liquidation in 1999.

28. As the large fiscal imbalances were significantly corrected from 1994 to 1996, the above pressures started to subside. In addition, some positive external shocks, including the shift of Ethiopia's transit trade to Djibouti and the increase in foreign military, helped in bringing some breathing space to the economy. In the end, the currency board could withstand the pressures that arose from the fiscal imbalances, probably because of the main following reasons:

- The local banks, which are subsidiaries of large foreign banking groups had steady access to international financing. This access somewhat helped alleviate the liquidity constraint that is imposed by the lack of a lender-of-last-resort, and can explain why the dynamics of the balance of payments did not affect significantly the dynamics of domestic credit.[37]

- The central bank continued to maintain a high level of foreign assets to cover the monetary base, in excess of the 100 percent requirement; since the central bank law does not allow the central bank of Djibouti to use the resources in excess of the requirements, this excess coverage likely contributed to maintain confidence.

- The trade system remained fully open, without recourse to protective tariffs and non-tariffs, and capital movement continued to be free, which has yielded a very high level of openness. In these circumstances, Djibouti has always been a regional center for services.

[37] In the context of a CBA, the banks' capacity to provide credit to the economy is predicated on a steady flow of foreign currency; therefore, the country needs to run a current account surplus and/or be the recipient of capital flows in the form of foreign direct investment.

Table II.4. Djibouti: Selected Economic Indicators, 1993–2002

(In percent of GDP; unless otherwise indicated)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Annual inflation (annual percent change)	4.4	6.5	4.9	3.5	2.5	2.2	2.0	2.4	1.8	0.6
Change in real GDP (in percent)	-6.7	-0.9	-3.5	-4.1	-0.7	0.1	2.2	0.7	1.9	2.6
Interest rate (average deposit rate)	2.7	3.9	5.2	3.6	3.6	3.9	3.8	4.5	2.9	1.2
Foreign reserves (in millions of U.S. dollars)	75.1	78.6	71.4	77.0	67.8	64.4	70.4	67.6	70.3	74.5
Foreign currency deposits (in millions of U.S. dollars)	134.4	123.6	156.9	139.7	146.6	140.9	145.7	142.5	148.3	178.5
Share of Foreign currency deposits (in percent of total deposits)	53.9	49.0	58.1	59.2	62.9	62.0	60.6	58.4	55.8	57.4
Real effective exchange rate (index, 1990=100)	108.3	110.5	105.3	109.7	120.8	128.7	129.5	139.3	146.1	141.2
Real effective exchange rate (annual percent change)	7.2	2.0	-4.7	4.2	10.1	6.5	0.6	7.6	4.9	-3.4
Exports (in millions of U.S. dollars)	236.3	218.1	63.5	63.8	64.3	80.6	90.9	100.6	100.1	105.4
Current account (including official transfers)	-5.7	-7.5	-3.4	-3.3	-2.3	-0.6	-0.4	-7.2	-4.3	-6.2
Current account (excluding official transfers)	-25.1	-20.9	-15.5	-14.8	-14.4	-15.1	-13.3	-18.0	-10.8	-13.7
Government debt	...	...	54.0	57.1	60.4	59.6	58.8	81.2	78.6	78.9
Total public sector external debt	57.1	59.9	53.3	57.6	63.0	65.5	62.8	66.9	65.2	66.8
Gross domestic expenditures	127.8	122.1	116.7	116.0	115.1	116.1	114.5	119.6	112.0	115.0
Consumption Expenditure 1/	110.4	110.5	108.3	106.9	105.7	100.8	105.7	107.4	103.7	104.8
Central government	44.1	34.2	32.4	27.7	27.8	23.5	26.1	25.8	23.4	25.1
Nongovernment	66.2	76.3	75.9	79.2	77.9	77.3	79.6	81.6	80.3	79.7
Investment 2/	17.5	11.6	8.4	9.1	9.4	15.3	8.8	12.2	8.3	10.2
Government	8.3	5.5	3.6	3.9	4.3	6.6	3.1	2.7	2.5	3.7
Nongovernment 3/	9.2	6.1	4.8	5.2	5.1	8.6	5.7	9.6	5.8	6.5
Domestic savings	-10.4	-10.5	-8.3	-6.9	-5.7	-0.8	-5.7	-7.4	-3.7	-4.8
Government	-13.7	-7.8	-6.4	-1.8	-3.8	-1.3	-6.5	-5.7	-3.9	-5.7
Private	3.4	-2.7	-1.9	-5.1	-1.9	0.5	0.8	-1.7	0.2	0.9
Net current transfers and factor income	22.1	14.6	13.3	12.7	12.8	15.4	14.2	12.5	7.6	8.6
Net current transfers	17.2	11.3	9.9	9.5	10.4	13.4	11.9	9.6	5.4	6.9
Net factor income	4.9	3.4	3.5	3.2	2.4	2.1	2.3	2.9	2.2	1.8
National savings 4/	11.8	4.1	5.0	5.8	7.1	14.6	8.4	5.1	3.9	3.8
Saving/Investment gap 5/	-5.7	-7.5	-3.4	-3.3	-2.3	-0.6	-0.4	-7.2	-4.3	-6.4

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

1/ The high level of consumption and negative domestic savings are permitted by large inflows of external grants.
2/ Equals gross capital formation.
3/ For 1998, data include imports of electricity generators equivalent to 2 percent of GDP. For 2000-2002, data include investment in cement plant equivalent, on a cumulative basis, to 4 percent of GDP.
4/ National savings is defined as domestic savings plus net current transfers and factor income from abroad.
5/ The saving/investment gap corresponds to the external current account balance including current grants.

Box II.3: The Domestic Payment Arrears Problem

The significant rise in the level of domestic arrears can be traced back to the early 1990s after the outbreak of the ethnic-based conflict in 1992. That year, the government ordered a general mobilization, which led to the hiring of 12,000 additional military personnel. To finance these supplementary outlays, the government introduced a patriotic contribution equivalent to a 10 percent levy on all salaries exceeding DF 60,000 (around $338), expected to last one year. While this new tax contributed to the rise in the ratio of revenue to GDP (up to 1.4 percentage points of GDP in 1992–93), the budget deficit, nonetheless, widened significantly. In the face of rapidly diminishing external support, (which dropped from 6.6 percent of GDP in 1990 to 3.2 percent of GDP from 1993 to 94), and growing financing needs (which rose heavily during the same period from 2.1 percent of GDP to 8.5 percent of GDP), the government resorted to domestic financing (rising by 8.3 percentage points of GDP from 1990 to 94). The government started by withdrawing its deposits from the central bank as well as from commercial banks. When these deposits proved insufficient to cover the growing needs of the government, the authorities resorted to nonbank sources, by forcing public enterprises to make budget contributions, loans, and cash advances. With financial needs not yet fully covered, the government stopped repaying the short-term certificates of deposit owned by public enterprises for a total equivalent to 3 percent of GDP. By 1993, after the recourse to domestic financing became unsustainable, the accumulation of domestic and external arrears on salaries, private suppliers, pension funds, and public enterprises started to accelerate, leading to major financial imbalances and economic stagnation.

In June 2002, the government completed two audits of domestic payment arrears that were accumulated throughout the 1990s. While the first exercise, which was sponsored by the European Union, covered claims on the private sector, the second, undertaken with financial support from the World Bank, reviewed the findings of the first audit, and extended the audit to cover the arrears payments on government salaries, claims on and from public enterprises, and pension funds. For both audits, the cutoff year was 1996, since documentation prior to this year was destroyed in the flooding of the treasury building that year.

These two audits enabled the Djibouti government to validate an overall stock of domestic arrears payments of DF 29 billion as of end-2000, of which: (i) DF 1.7 billion were to the private sector; (ii) DF 7.7 billion on wages outstanding for FY1995, FY1997, and FY2000; and (iii) DF 19.5 billion to government agencies (including pension funds) and public enterprises. In line with the plan adopted in early November 2002 by the government, these arrears are expected to be repaid over a period of 10 years. The plan established clear priorities for repayments to the creditors whose claims were validated using three key principles, namely (i) the financial situation of the creditors whose claims were validated; (ii) the propensity to reinvest cash to be received into the domestic economic system; and (iii) the capacity of the beneficiary to engage in poverty-reduction activities. Consistent with these principles, private suppliers topped the list of claimants, followed by the civil servants, the pension funds, and finally the public enterprises. In the case of the civil servants, the plan calls for the repayment of an amount equivalent to one full month's salary per year. Regarding the pension funds, the repayment plan takes into account their cash requirements for meeting their pension obligations to those eligible for retirement. The same approach of *repayment on a need basis only* was retained for public enterprises, so that clearing of arrears to these institutions will be made once their liquidity needs are identified through financial audits.

IV. The Path for Future Fiscal Consolidation

29. **Looking ahead, a critical issue is whether the authorities will pursue fiscal consolidation in a steady fashion in light of pressures on the government to increase spending to implement its poverty reduction strategy and restore external competitiveness.** There are grounds for optimism but also serious reasons for caution. On the positive side, first, the authorities now have, at their disposal, a full array of instruments and regulations to help them prioritize, monitor, and control public spending. Second, there is an

urgent need for the government to maintain the momentum for expenditure restraint to free resources to clear domestic arrears, help restore the government's financial credibility, and revive economic growth. Finally, partners who support Djibouti's reform program and are expected to provide funding for the poverty alleviation strategy press for more fiscal transparency. On the downside, the weak institutional and managerial capacity may hamper efforts to fully take advantage of all the reforms introduced so far regarding public expenditure management. In addition, political pressures are building to relax fiscal discipline. These pressures occurred in the run up to and after the January 2003 legislative elections, which the governing coalition won by a modest margin, and are increasing in the perspective of the presidential election of May 2005. This risk is compounded by the general feeling within government circles that financial easiness is fueled by the securing of additional resources from military cooperation (resources equivalent to 4.5 percent of GDP as an annual basis for the next few years)[38] and the reemergence of the strategic importance of Djibouti for some major donors.

30. **Fiscal consolidation could be sustained further from the introduction of the remaining fiscal reforms on the agenda on both the tax and expenditure sides.** Additional spending cuts, other than the wage bill, are not desirable at this stage; in fact, more capital spending in line with the implementation capacity of the country is expected in order to implement the government's poverty reduction strategy.

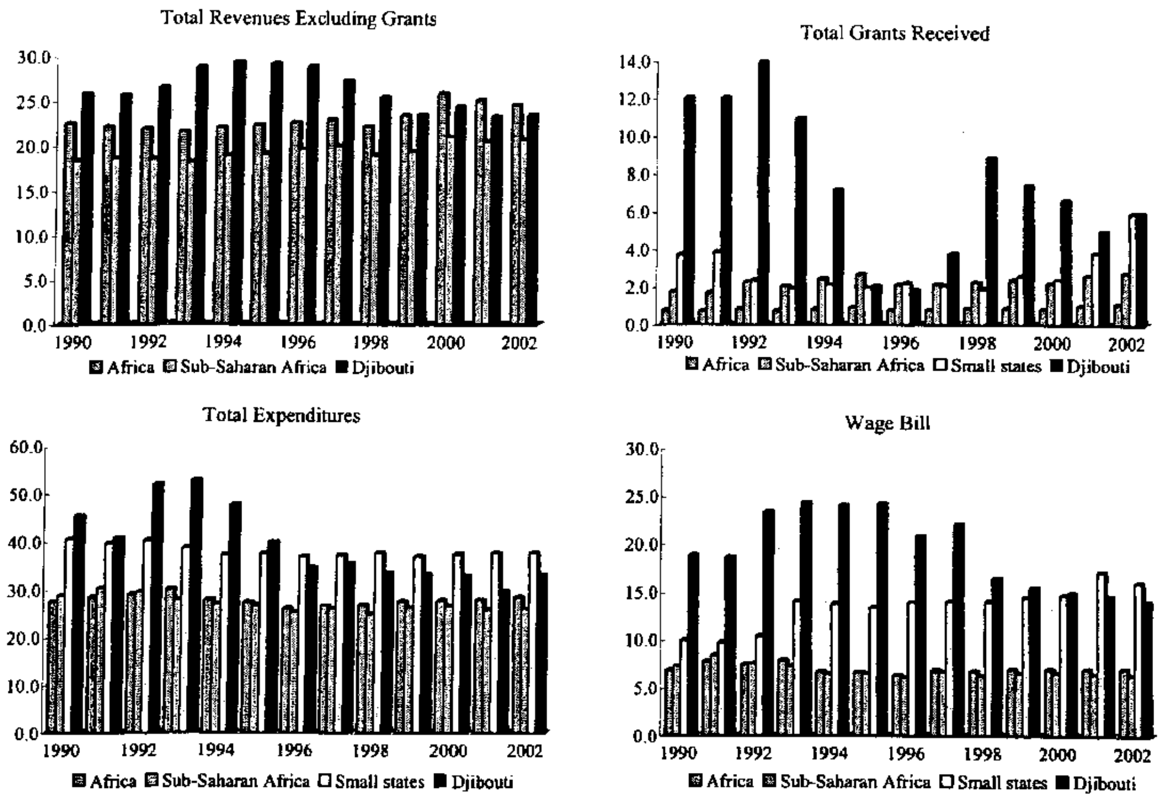
31. Despite the progress Djibouti has made so far in improving its tax system, strengthening budget procedures, and enhancing transparency in government finance, **there are still some weaknesses in both the tax and spending areas.** The tax system (Box II.4) remains distorted and fragile, as evidenced by (i) the heavy reliance on direct taxation, (ii) a tax base eroded by a web of exemptions; (iii) a distorted taxation on consumption; and (iv) weak tax administration. On the spending side, the reorganization of the ministry of finance to facilitate budget preparation executions and control, while giving line ministries greater autonomy to initiate expenditures, has yet to be completed. Furthermore, the reforms introduced need to be fully implemented so that they can produce the expected positive impact on spending.

32. The implementation of additional reforms would most probably help Djibouti (i) strengthen the fiscal consolidation gains made so far; (ii) maintain fiscal discipline in the face of expenditure pressures arising from poverty reduction policy actions and political pressures; (iii) further reduce the stock of domestic payment arrears; (iv) build a more rational tax structure that generates more revenue from consumption; and (v) reorient the

[38] These resources will be provided by France under a revised fiscal regime applicable to its armed forces stationed in Djibouti and by the United States for the recent lease of military facilities.

composition of expenditure by reducing the wage bill and allocating more resources to priority sectors to improve the quality and efficiency of public services and reduce poverty.[39]

Figure II.1 Djibouti and Comparator Countries, 1990–2002
(In percent of GDP)



Sources: World Bank, World Development Indicators 2002 ; GFS; WETA; WEO; and Fund staff estimates.

[39] Compared with other sub-Saharan African countries, Djibouti has a higher level of budgetary revenue by about 3 percent of GDP in 2000–2002 and receives larger external grants, but its central government spends 4.6 percent more of its GDP, and maintains a wage bill twice as large see (Figure II.1 and Table II.5).

Box. II.4. The Tax System

Direct Taxes

Individual income taxes

Revenue from individual income taxes represented about 4.4 percent of GDP (21 percent of total revenue) in 2002. Since the reform of 2001, this tax is a progressive monthly levy on a combined income derived from all wages, benefits in cash, pensions paid in Djibouti, as well as the patriotic contribution. The tax is payable by the employee who now files under a new self-assessment system. The various marginal tax rates are as follows: 2 percent (DF 0–DF 300,000); 15 percent (DF 30,000–DF 50,000); 18 percent (DF 50,000–DF150,000); 20 percent (DF 150,000–DF 600,000); and 30 percent (over DF 600,000).

Corporate taxes

Corporate income taxes amounted to 3.9 percent of GDP (18 percent of total revenue) in 2002. Corporate taxes comprise the following four categories: the business lump sum tax; tax on professional earnings; taxes on business profits of individuals; and company profits tax, and a minor tax on real estate capital gains. All natural or legal persons exercising handicraft, commercial, or industrial activities or liberal professions are subject to a tax of 1 percent of turnover that would not exceed DF 120,000. Net profits up to DF 600,00 made by professionals or the remuneration of business operators who have a controlling interest in their companies are subject to a 25 percent tax. The same rate applies to net annual profits generated by unincorporated industrial, commercial, or craft enterprises, and also to profits made by joint stock companies, cooperatives, and partnerships (including government-owned enterprises, mixed economy enterprises, and industrial or commercial public enterprises. A 5 percent tax is levied on real estates or land transactions. As part of its agenda to simplify the tax system along the line of a rational scheduler tax system, the authorities intend to merge, during 2003, all these taxes and, instead, put in place one synthetic tax.

Property taxes

Property tax revenue amounted to 0.6 percent of GDP in 2002 (2.9 percent of total revenue). Property taxes are levied on real estate operations, including transfers of property, and land registration.

Indirect taxes

Domestic sales tax

Domestic sales tax represented 6.9 percent of GDP (63 percent of total revenue), of which 1 percentage points of GDP is derived from oil products. The rest comes from taxation on khat, tobacco, alcohol, and other products). This tax is levied on all goods imported into and consumed in Djibouti. There are three standard rates 10, 20, and 33 percent. Some particular products like dairy products, fruit juices, toiletries, and perfumes are subject to a specific tax.

Excise taxes

Excise taxes amounted to 4 percent of GDP (37 percent of total revenue). Excise taxes are levied on khat, tobacco, alcoholic beverages, oil products, and other goods. The tax rate on champagne and brandies is 160 percent of c.i.f. value, and that on tobacco is 27 percent. Table wines are subject to a specific tax of DF 100 per liter, other alcoholic beverages DF 4,700 per liter, regular and premium gasoline DF 90 per liter, and khat DF 561 per kilogram gross weight.

Other taxes

Tax on car registration as well as stamps issued for government transactions amounted to 0.9 percent of GDP (9.7 percent of total revenue) in 2002.

Nontax revenue

Nontax revenue amounted to 2.4 percent of GDP (26.9 percent of total revenue). This included user fees on oil (1.1 percent of GDP), administrative fees and charges (0.7 percent of GDP), dividend payments from public enterprises (0.2 percent of GDP), rental proceeds for government housing and land (1 percent of GDP), and sale of government property (0.2 percent of GDP).

Strengthening tax administration

33. **Djibouti will need to build further on the reforms already implemented and step up efforts to modernize its tax system, broaden its domestic tax base, and increase its efficiency.** Of particular importance is the need to complete the move to a full self-assessment system by putting into place a single tax on professional profits that would unify all the current taxes on profits,[40] as well as a single tax on real and financial assets. A self-assessment tax system will allow prompt payment by taxpayers with limited intervention from the tax administration. Together with this move to full self-assessment, Djibouti needs to gradually eliminate the flat rate tax on businesses.

Table II.5 Djibouti and Comparator Countries: Fiscal Indicators, 1990–2002 1/

(In percent of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Total revenues including grants													
Africa	23.2	22.8	22.7	22.3	22.8	23.2	23.3	23.7	23.0	24.3	26.6	26.1	25.6
Sub-Saharan Africa 2/	20.1	20.3	20.7	20.1	21.3	21.7	21.7	22.1	21.2	21.6	23.2	23.1	23.5
Small states 3/	35.8	35.5	34.3	34.4	32.5	33.0	31.9	32.7	32.3	31.9	33.8	33.0	32.8
Djibouti	37.9	37.7	40.4	39.6	36.5	31.1	30.6	31.0	34.2	30.9	31.0	28.2	29.4
Total revenues excluding grants													
Africa	22.5	22.1	21.8	21.5	22.0	22.3	22.6	22.9	22.1	23.4	25.8	25.1	24.6
Sub-Saharan Africa 2/	18.3	18.6	18.5	18.1	18.9	19.0	19.6	19.9	18.9	19.3	21.0	20.5	20.7
Small states 3/	...	...	...	...	...	...	...	...	...	...	...	...	...
Djibouti	25.8	25.6	26.4	28.7	29.3	29.1	28.8	27.2	25.4	23.5	24.4	23.3	23.5
Total grants													
Africa	0.7	0.7	0.8	0.8	0.8	0.9	0.7	0.8	0.9	0.9	0.8	1.0	1.1
Sub-Saharan Africa 2/	1.7	1.7	2.2	2.1	2.4	2.6	2.1	2.1	2.2	2.4	2.2	2.6	2.7
Small states 3/	3.7	3.9	2.4	1.9	2.1	2.0	2.2	2.1	1.9	2.6	2.4	3.8	5.9
Djibouti	12.1	12.0	13.9	11.0	7.2	2.0	1.8	3.8	8.9	7.4	6.6	5.0	5.9
Total expenditures													
Africa	27.3	28.4	29.0	30.0	27.8	27.3	26.0	26.6	26.7	27.5	27.6	27.8	28.3
Sub-Saharan Africa 2/	28.6	30.2	29.4	27.7	26.9	26.6	25.2	25.9	24.8	26.1	26.4	25.8	26.0
Small states 3/	40.4	39.6	40.2	38.6	37.1	37.4	36.7	37.1	37.5	36.8	37.3	37.5	37.6
Djibouti	45.2	40.6	51.8	52.6	47.6	39.8	34.5	35.3	33.3	33.1	32.8	29.7	32.9
Wage bill													
Africa	6.8	7.7	7.4	7.8	6.7	6.6	6.3	6.8	6.7	6.9	6.9	6.9	6.9
Sub-Saharan Africa 2/	7.2	8.3	7.5	7.3	6.4	6.4	6.0	6.6	6.2	6.5	6.5	6.3	6.3
Small states 3/	9.9	9.7	10.4	14.0	13.8	13.4	13.9	14.0	14.0	14.5	14.6	17.0	15.9
Djibouti	18.8	18.6	23.3	24.3	24.0	24.2	20.8	22.0	16.4	15.4	14.9	14.5	14.0

Sources: World Bank, World Development Indicators 2002 ; GFS, WETA, WEO, and IMF staff estimates.

1/ As of September 2002 for Africa and Sub-Saharan Africa.
2/ Sub-Saharan Africa group excludes Algeria, Morocco, Nigeria, South Africa, and Tunisia .
3/ Small states are IMF members with population of less than one million.

34. Moreover, there is a need to (i) simplify and rationalize the tax exemptions and the various preferential tax systems in place (Box II.4); (ii) target tax exemptions that could take the form of an accelerated amortization of real assets instead of temporary tax exemptions; (iii) monitor closely enterprises which benefit from these exemptions in order to ensure full compliance; and (iv) entrust one authority—namely the ministry of finance—to grant and withdraw exemptions.At the same time, to provide a solid foundation for this self-assessment

[40] This reform must be accompanied by a full simplification of the amortization schedules relating to the commercial and industrial profits.

system, Djibouti needs to strengthen tax controls and put in place an effective system for identification of tax delinquents as well as strengthened procedures to collect tax arrears. Furthermore, the authorities should strengthen their fiscal audit to cover the full range of taxes, and reinforce their verification unit to conduct on-site visits and recoveries.

35. **The extension of the domestic tax base is another area for further reform.** Currently, revenue from direct taxation represents about 40 percent of total budgetary revenue, compared with an unweighted average in Sub-Saharan Africa of 23.2 percent of tax revenue. This highlights the need for the government to restructure the entire tax system and shift away from taxing income and production and move toward taxing more consumption. The pillar of any upcoming tax reform should be the introduction of a value added tax (VAT), together with customs duties in line with the external tariff adopted by the COMESA (Common Market for Eastern and Southern Africa).[41]

36. The authorities are planning to introduce a VAT by January 2006, a move expected to improve the efficiency of the tax system. The system could be further strengthened if Djibouti uses this opportunity to review the buoyancy of other indirect taxes such as the excises on tobacco and alcohol. A critical step toward introducing a VAT will be the integration of the tax management, control, and recovery functions into a single unit.

Improving public expenditure management

37. **On the expenditure side, the authorities ought to be able to achieve the reorganization of the ministry of economy and finance so as to establish the adequate institutional framework needed to restore the budget preparation function and eliminate redundancies in the area of budgetary control.**[42] Furthermore, this reorganization will help the transfer of expenditure authorizations to line ministries that have the necessary staff and administrative capacity before extending it to other ministries.[43]

Changing the structure of spending

38. **Another challenge is to ensure that public expenditures in the years ahead are fully consistent with the priorities expressed in the Poverty Reduction Strategy Paper (PRSP).** This means that (i) more resources are allocated to social sectors; (ii) a clear prioritization is introduced among the numerous poverty-reducing projects; and (iii) a reliable tracking mechanism is established to monitor the implementation of the PRSP-

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[41] Domestic consumption tax represents about 63 percent of total indirect tax revenue, while the excise tax on khat amounts to about 20 percent; the share of excise tax on petroleum is

4 percent. The remainder (13 percent) is represented by various excise taxes on alcohol, tobacco, mineral water, and fruit juices.

[42] A critical step toward fully implementing this reorganization is to adopt and implement the application decree, a draft of which was prepared by an IMF resident expert.

[43] In the meantime, the staff of other ministries will benefit from a training program aimed at familiarizing them with the new budgetary procedures in a new environment.

induced investment program. For that purpose, Djibouti should conduct without delay a Public Expenditure Review (PER) to analyze the pattern and evolution of public expenditures, and recommend ways to improve their impact on poverty reduction. The PER should first focus on three critical sectors, namely education, health, and water supply. At the same time, the PER should evaluate Djibouti's institutional capacity to implement the poverty reduction programs included in the PRSP and recommend measures for raising that capacity. It is already clear, however, that the authorities will need to further lower the wage bill without compromising the quality of services. The government wage bill (Box II.6), whose share of GDP is one of the highest in Africa, could be reduced significantly through the steady pursuit of demobilization of the military and the retirement of civil servants.

Box II.5. The Tax Incentive System for Private Investment

Simplifying and rationalizing the various tax exemption systems is essential for expanding the tax base. Currently, there are five exemption systems: the Investement code (IC); the Regime of the Djibouti Free Trade Zone (RDFZ); the Business Corporations of the Free Trade Zone (BCFZ): the Regime of the Free Zone Enterprises (RFZE); and the Industrial Free Trade Zone (IFTZ). These different systems, which govern all investment projects by Djibouti nationals and foreigners, provide a complex set of generous privileges.

The Investement code for example provides significant tax breaks for private entrepreneurs investing up to DF 50 million ($280,000). They are exempt from the business tax as well as the general consumption tax for as long as they operate their firm. If the investment exceeds DF 50 million, the entrepreneur is exempt from the business tax, the property tax, and the profit tax for a period of 10 years. Under the regime of the business corporations of the free trade zone regime, the entrepreneurs are fully exempt from any taxation.

The exemptions introduce discriminatory treatment against domestic producers. These exemptions benefit from 1,500 to 2,000 small entrepreneurs. They are complicated and lack total transparency. They are also awarded to entrepreneurs on a discretionary basis by various government agencies.

The government is preparing a new investment code. The review of the investment incentives aims at providing a legal framework for private investment which is transparent, simple, and investor-friendly. A new investment code will lay out the technical and institutional aspects facilitating private investment in Djibouti. Fiscal incentives, which will remain in effect after the full simplification, rationalization, and merger of all previous systems, will be incorporated in the tax code. In line with the new investment code, the National Agency for Promoting Investment (***Agence Nationale pour la Promotion des Investissements***) will be in charge of authorizing requests for tax privileges for new private investments.

Major revisions to past practices should include the elimination of the exemption on the consumption tax on capital equipment and imports of raw materials, which would both be replaced by a reduced 3 percent rate, and a reduction of the tax holiday on the business tax ***(patentes)*** and profit tax from 10 to 5 years.

Under the new regime of the investment code, the monitoring of tax holidays would be under the authority of the directorate of revenue. Should an investor be found not complying with the terms of the tax holidays, the directorate of revenue will have the authority to suspend all privileges and request collection of back taxes due, and the national commission for investments would withdraw the investment license.

Box II.6. The Government Wage Bill

In the early 1990s, the public wage bill[1] represented on average 19 percent of GDP before rising to around 24 percent of GDP during the period 1993–95, mainly as a result of the mobilization of security personnel in the face of ethnic strife. This trend started being reversed in 1995, and the government wage bill was reduced (from 24.2 percent of GDP in 1995 to 16.4 percent of GDP in 1998), on account of several measures introduced during that period, including the partial demobilization of 1,500 soldiers, the elimination of irregularities in employment and cash allowance surveys, the cutback in benefits and salaries of embassy personnel, and the elimination of overtime work.

The expenditure curtailments, a major component of Djibouti's stabilization efforts since 1996, have been instrumental in bringing down the share of wages and salaries in GDP to 14 percent by 2002. While this share is slightly less than the 15.9 percent prevailing in some small states, it, nevertheless, exceeds significantly the share of about 6.9 percent for Africa as a whole and 6 percent for sub-Saharan Africa.

Even considering measures taken so far, including the 10 percent cut in nominal wages exceeding DF 80,000 per month in 1998, the **wage bill still represents 48 percent of current spending**, absorbs almost 60 percent of total revenue, and is equivalent to total exports of the country. With virtually no room for spending restraint on other non-wage aggregates, policy actions on the wage bill are crucial steps in allowing reallocation of spending in favor of priority social sectors; and maintaining control of the public finances in Djibouti.

[1]The public wage bill includes salaries for employees of the central government as well as those of institutions like the universities, the constitutional council, the ombudsman's office, and the national assembly.

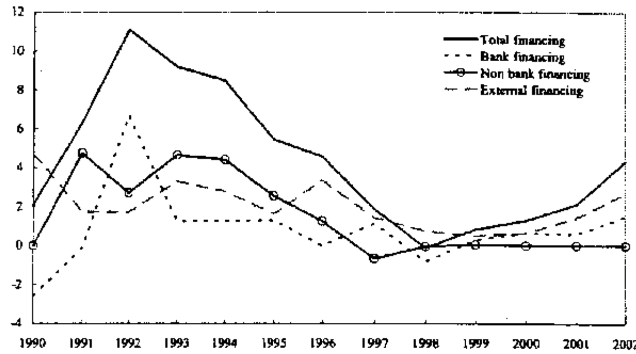
V. Medium-Term Fiscal Sustainability [44]

A. Medium-Term Outlook

39. **Over the next five to ten years, increasing pressure on government expenditure will arise from, inter alia, the cost of public enterprise reforms, the infrastructure investment needed to boost productivity and restore external competitiveness, and poverty alleviation actions.** These pressures for more outlays will take place against the background of commitments under international trade agreements to restructure external

[44] The assessment of fiscal sustainability and vulnerability of Djibouti will be limited in coverage and does not take into account the risks that could be posed by adverse future economic and financial outcomes. The analysis will focus only on debt, and will not cover contingent assets and liabilities and other components of the public balance sheet, if any.

Figure II.2 Domestic and External Government Financing, 1990- 2002
(In percent of GDP)



Sources: Djibouti Authorities; and Fund staff estimates.

tariffs,[45] which at best are expected to be revenue neutral. At the same time, the authorities intend to pursue expenditure management and revenue reforms to strengthen fiscal transparency. In this context, Djibouti will need to prudently manage its public finances in order to maintain fiscal sustainability and as a necessary (but not sufficient condition) to protect, the integrity of the currency board arrangement. The sustainability of the medium-term fiscal program is a challenge for the government; in other words, it is important to examine conditions needed for stabilizing the total government debt-to-GDP ratio over the medium term at a level consistent with the government's fiscal priorities and with macroeconomic stability.[46]

40. An assessment of the current situation reveals that while fiscal policy is conservative, the debt level remains high, particularly the domestic component. Fiscal impulse analysis shows that since 1998, the fiscal stance has been tight. As a result, the net external financing of the central government fiscal deficit during the period 1998–2002 was reduced by 1.5 percent of GDP, compared with an average of 2.3 percent of GDP from 1994 to 1997 (Figure II.2). Total public external debt stands at $396 million (67 percent of GDP) at end-2002, one of the highest ratios among developing countries (Table 5), of which government external debt represents 51 percent of GDP. More worrisome is the stock of domestic debt, mostly on account of arrears, which amounted to about 28 percent of GDP at end-2002. In line with the plan adopted in October 2002, the government intends to make annual payments of DF 2.5 billion over a period of 10 years beginning in 2003 so as to clear the entire stock of validated domestic payment arrears.

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[45] In the context of commitments under the COMESA regional trade arrangement, Djibouti is expected to introduce a common external tariff as of January 2004. It is likely, however, that Djibouti will request a delay for implementating this reform.

[46] The analysis would have taken into consideration total public sector debt, but this was impossible since no consolidated data on public sector accounts were available.

Table II.6. Djibouti: Ratios of External Indebtedness of Developing Countries, 1995–2002

(In percent of GDP)

	1995	1996	1997	1998	1999	2000	2001	2002
Developing countries	41.5	39.4	38.7	43.5	44.7	40.6	40.1	40.9
Regional groups								
Africa	72.1	67.7	63.5	65.9	65.5	63.0	61.0	59.3
Sub-Sahara	72.1	68.7	64.2	67.6	68.2	67.0	66.1	63.5
Developing Asia	32.6	31.1	32.5	37.0	34.1	30.7	29.9	27.4
Excluding China and India	52.5	51.4	59.1	84.7	72.2	65.4	65.4	57.7
Middle East and Turkey	58.5	55.5	54.8	63.0	62.5	59.2	61.2	62.7
Western Hemisphere	36.9	35.5	33.7	37.9	44.3	38.7	38.9	45.3
Djibouti	53.3	57.6	63.0	65.5	62.8	66.9	65.2	66.8

Source: WEO, September 2003.

41. **The medium-term fiscal sustainability[47] for Djibouti was assessed on the basis of the most recent medium-term fiscal framework for the period 2003–08.** This medium-term fiscal framework, which was updated in July 2003, is based on the latest WEO projections and reflects policy actions already taken by the authorities or assumptions about those measures expected to be introduced on the revenue, expenditure, and financing side. It was also revised to include additional resources expected from bilateral donors, as well as new spending envisaged by the authorities in the context of their poverty reduction strategy. The additional revenue is equivalent to 4.5 percent of GDP on an annual basis (see section IV). On the expenditure side, the decline in current outlays—notwithstanding additional spending on social sectors—expected essentially from a reduction of the wage bill (through the pursuit of demobilization and retirement programs), and rationalization of expenditure in goods and services, will be partially offset by a significant rise in domestically-financed capital spending linked to the implementation of the government's poverty reduction investment program. On account of all these elements, total spending is expected to reach almost 34 percent of GDP by 2008, up from 32 percent of GDP in 2002. In line with the plan adopted in October 2002, the government is also expected to honor its commitments to creditors whose claims in arrears were validated; thus clearance repayments of domestic arrears, representing on average 2 percent of GDP per year, are factored in the medium-term fiscal program. On the financing side, the projected level of external disbursements (3 percentage points of GDP on an annual basis from 2003 to 2008) represents mainly project aid expected to be mobilized in support of the government's poverty reduction investment

[47] Fiscal sustainability is defined as the fiscal position that maintains debt at a level that can be serviced without an undue burden of adjustment.

program.[48] Table II.7 presents the medium-term baseline scenario for the central government fiscal accounts.

Table II.7. Djibouti: Central Government Financial Operations, 2002–08

(In percent of GDP)

	2002	2003	2004	2005	2006	2007	2008
				Rev. Proj.			
Revenues and grants	29.4	34.5	33.7	33.4	31.5	32.0	31.3
Total revenue	23.5	27.7	27.3	26.8	26.0	25.4	25.1
Fiscal revenue	21.1	22.8	22.4	21.8	21.2	20.7	20.3
Direct taxes	9.3	9.4	9.2	8.9	8.6	8.2	8.0
Indirect taxes	11.7	13.4	13.2	12.9	12.6	12.4	12.3
Non tax receipts	2.4	4.8	4.9	4.9	4.9	4.7	4.8
Official grants	5.9	6.9	6.4	6.6	5.5	6.6	6.2
Total expenditure	32.9	35.6	36.3	36.4	34.7	33.9	33.4
Current expenditure	29.2	31.2	29.1	27.9	26.6	25.7	25.2
Wages and salaries 1/	14.0	13.9	12.9	12.2	11.5	10.8	10.0
Materials	6.2	6.9	6.3	5.3	4.9	4.6	4.3
Maintenance	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Transfers	3.9	3.9	3.6	3.4	3.1	2.9	2.7
Interest	0.2	0.6	0.5	0.5	0.4	0.4	0.4
Foreign-financed development programs	3.6	4.5	3.5	3.2	2.7	2.2	2.0
Incremental social programs	0.7	0.7	1.6	2.3	2.8	3.7	4.3
Recurrent charges	0.0	0.2	0.3	0.5	0.6	0.6	0.9
Investment expenditure	3.7	4.3	7.1	8.5	8.1	8.1	8.1
Domestically-financed	0.6	1.7	0.5	0.5	0.5	0.7	1.0
Foreign-financed	3.2	2.7	6.6	8.0	7.6	7.4	7.1
Overall balance (payment-order basis, including grants)	-3.5	-1.0	-2.5	-3.1	-3.2	-1.9	-2.0
Change in arrears (cash payments = -)	-0.7	-2.9	-2.4	-2.0	-1.9	-1.8	-1.7
Overall balance (cash basis)	-4.2	-3.9	-4.9	-5.1	-5.1	-3.7	-3.7
Financing	4.2	3.9	2.8	2.7	2.6	2.3	2.5
Domestic financing	1.5	0.7	-0.3	-0.4	-0.4	-0.5	-0.3
Bank financing	1.5	0.7	-0.3	-0.4	-0.4	-0.5	-0.3
Non bank financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0
External financing net	2.7	3.2	3.1	3.0	3.1	2.9	2.8
Disbursements	3.3	3.9	3.6	3.5	3.5	3.3	3.2
Amortization payments	-0.6	-0.6	-0.5	-0.5	-0.5	-0.5	-0.4
Financing gap	...	...	2.1	2.4	2.5	1.4	1.2
Overall balance before grants (payment-order)	-9.4	-7.9	-8.9	-9.7	-8.6	-8.4	-8.3
Overall balance before grants (cash basis)	-10.1	-10.8	-11.3	-11.7	-10.6	-10.2	-9.9

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

1/ Includes severance payments to military personnel being demobilized.

42. **The medium-term fiscal framework is anchored in a baseline scenario that assumes an (i) average real GDP growth rate of 3.8 percent a year over the period 2003–08, and (ii) real interest rate of about half of 1 percent.** The medium-term growth

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[48] It is assumed that 30 percent of this additional aid will be in the form of grants, consistent with the current structure of project aid to Djibouti.

assumption of 3.8 percent exceeds the growth performance recorded since 1991. Construction of a new modern port in Doraleh (near the capital city) and the gradual increase in public investment in support of the government's poverty reduction strategy are expected to be the main forces behind this growth target. However, there is a risk that the local capacity constraints may slow the implementation of the port project and the public investment program.

Table II.8. Djibouti: Minimum Primary Balance Required to Maintain the Government Debt to GDP Ratio Constant

(In percent of GDP)

Real Interest on Public Debt	Real GDP Growth Rate				
	1.0	3.0	4.0	5.0	7.0
-1.0	-1.6	-3.1	-3.9	-4.7	-6.3
1.0	0.0	-1.6	-2.4	-3.1	-4.7
3.0	1.6	0.0	-0.8	-1.6	-3.1
5.0	3.1	1.6	0.8	0.0	-1.6
7.0	4.7	3.1	2.4	1.6	0.0
10.0	7.1	5.5	4.7	3.9	2.4

Source: Fund staff estimates.

B. Assessing Fiscal Sustainability

43. The government-debt-to-GDP ratio, which deteriorated sharply in 2000, has since improved slightly, and reached 78.9 percent at end-2002, a level that is still high, in comparison with other developing countries. In the context of its poverty reduction strategy, Djibouti intends to implement an ambitious investment program, which is not yet fully funded; it is assumed that the authorities will borrow up to 70 percent of the additional resources needed to cover the program in full.[49]

44. **While this will put pressure on the fiscal accounts, the ratio of government-debt-to-GDP ratio is expected to fall steadily, nevertheless, over the medium-term period to reach 61.1 percent of GDP by 2008.** This would mainly reflect a decline in domestic debt consistent with the implementation of the plan for clearing domestic arrears. Debt indicators derived from the latter are summarized in Table II.9 and Figure II.3.

[49] The structure of financing could be revisited as the poverty reduction strategy is implemented and the donors' support tested.

Table II.9. Indicators of Government Debt Sustainability, 2002–08

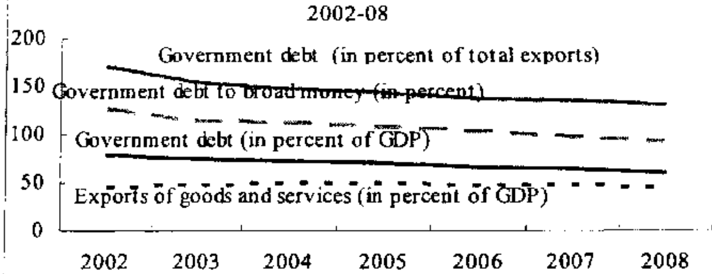
	2002	2003	2004	2005	2006	2007	2008
Exports of goods and services (in percent of GDP)	46.1	48.8	49.0	49.0	48.6	47.4	46.8
Interest payments (as a percent of exports of goods and services)	0.49	1.13	0.98	0.92	0.84	0.80	0.75
Debt service to exports (in percent)	1.5	2.5	2.7	2.5	2.4	2.3	2.5
Government debt (in percent of GDP)	78.9	75.1	72.7	70.2	67.4	64.2	61.1
Government debt (as a percent of exports of goods and services)	171.0	153.9	148.4	143.3	138.5	135.4	130.5
Government debt to broad money (in percent)	126.8	115.3	111.6	107.7	103.4	98.5	93.7

Sources: Djibouti authorities and Fund staff estimates and projections.

45. The positive government debt profile over the medium term in the baseline scenario is due in large part to the assumptions on real GDP growth and real interest rate (of 3.8 percent a year on average and half a percentage point, respectively). As discussed before, the projected growth is much stranger than historical standards. The low real interest reflects the fact that the government is not servicing any interest on its domestic debt (i.e., domestic arrears). And assumes that the government will continue to seek concessional external financing. Under these conditions, the government could record primary fiscal deficits of up to 2.4 percent of GDP while keeping the government debt to GDP ratio stable (Table 8).[50] Should real GDP growth and real interest rate not be as favorable, this would require from Djibouti to achieve much improved primary fiscal balances from the historical average of a 5 percent of GDP deficit in the last decade in order to maintain fiscal sustainability.

C. Sensitivity Analysis on Government Debt

Figure II.3. Indicators of Government Debt Sustainability, 2002-08

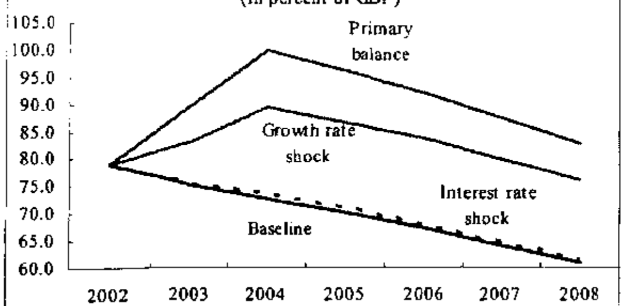


Sources: Djibouti authorities; and Fund staff estimates and projections.

[50] Taking 2001 as the base year, Table II.8 simulates the minimum required primary balance for various combinations of real GDP growth rates and real interest rates on government debt to keep the government debt-to-GDP ratio constant.

46. The sensitivity analysis assesses shocks arising from lower growth (at historical average plus two standard deviations in 2003 and 2004), real interest rates (at historical average plus two standard deviations in 2003 and 2004), and primary balance (at historical average minus two standard deviations in 2003 and 2004).

Figure II.4. Government Debt Sustainability Stress Tests, 2002-08
(In percent of GDP)



Source: Fund staff projections.

47. **Accordingly, the sensitivity analysis indicates that the projection is most sensitive to a deviation in the primary balance** (Table II.10 and Figure II.4). In the case of higher primary deficits, the government -debt-to-GDP would be 21 percent higher by 2006 than in the baseline. In the case of a GDP shock, the government debt-to-GDP ratio would be 15 percent higher. When setting real GDP growth, real interest rate, and the primary balance at their historical values, the government debt ratio would increase significantly to reach 97 percent in 2008, that is 36 percent higher than in the baseline scenario. All these results underscore the vulnerability of the fiscal accounts as government debt ratios would determine significantly and become unsustainable in the event of adverse shocks. This points to the need for the authorities to stand ready to introduce measures aimed at maintaining macroeconomic stability and sustaining strong economic growth in order to prevent fiscal deterioration. It will also be imperative that the authorities continue to adopt a very prudent external borrowing stance and seek only concessional external financing.

Table II.10. Government Debt Sustainability, 2002–08

(Government debt in percent of GDP)

	2002	2003	2004	2005	2006	2007	2008
Baseline	78.9	75.1	72.7	70.2	67.4	64.2	61.1
Growth rate shock	78.9	83.1	89.2	86.5	83.5	79.7	76.0
Interest rate shock	78.9	75.5	73.4	70.9	68.0	64.8	61.6
Primary balance	78.9	89.7	99.6	95.9	91.8	87.2	82.6
Real GDP growth, real interest rate, and primary balance	78.7	82.4	88.1	93.3	98.4	99.4	100.4

Source: Fund staff projections.

VI. CONCLUSION

48. Three main lessons can be drawn from the analysis above: (i) Djibouti managed to significantly improve its fiscal position since 1994 mainly through a reduction in spending. However, progress toward fiscal sustainability could not promote economic growth, as usually believed, because of remaining structural rigidities; but the dynamics of sustainable economic growth were not fully unlocked mainly because of the lack of flexibility in the labor market and an unfriendly business environment; (ii) fiscal reforms, (including simplifying the exemptions systems, introducing a VAT and further strengthening of expenditure management) should be pursued to provide the foundation for continued macroeconomic stability, which is a necessary (but not sufficient) condition for achieving higher sustained economic growth; and (iii) in order to reduce the government debt-to-GDP ratio as planned, the authorities will need to maintain a stronger fiscal balance than in the past, implement policies to achieve higher economic growth, and continue to adopt a very prudent external borrowing stance (including by seaking only concessional external financing).

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Djibouti: Historical Overview of Fiscal Adjustment

I. First Phase of Fiscal Adjustment: 1994–95

1. The period from 1994 to 1995 was a turning point in the path to financial stabilization during which the authorities resolved to reverse the decline in the economic and financial structure. The government tightened fiscal policy between 1994 and 1995, and set ambitious targets in terms of fiscal adjustment. The key objective was to bring down the fiscal deficit by almost 10 percentage points of GDP (down from 13 percent of GDP) through various revenue-enhancing and cost-cutting measures projected, which were, at that time, equivalent to 5.2 and 4.8 percent of GDP, respectively.

2. In the 1994 budget, the targeted reduction in the fiscal deficit was based on an increase in revenue equivalent to 3.2 percentage points of GDP, and a reduction in expenditures of 2.9 percentage points of GDP. Revenue measures included (i) raising taxes on salaries (by 3 to 5 percentage points) and profit taxation (by 5 percent to 25 percent), and (ii) raising the maximum "domestic consumption tax" rate (from 30 to 33 percent) and the surtax on petroleum products (ranging, in percent of oil prices, from 4.4 percent for diesel fuel to 20.8 percent for regular gasoline). Spending measures comprised a reduction in outlays on goods and services and transfers, and containment of personnel expenses (including through a partial demobilization of 1,500 military personnel out of a total of some 15,000 who were hired during the civil conflict in the early 1990s).

3. These policy actions were instrumental in reducing the deficit, but to a much smaller extent than envisaged, of about 2 percentage points of GDP. Thus, the fiscal situation still remained critical, prompting the authorities to introduce another series of corrective measures in the context of the 1995 budget. The revenue measures included (i) an increase in excise taxation on khat (DF 34 million); (ii) a rise in the patriotic contribution rate (additional tax levied on wages since the civil conflict) from 8 percent to 15 percent (DF 234 million); (iii) payment, by civil servants benefiting from free housing, of 20 percent of the market rental value (DF 64 million); and (iv) additional contributions and dividends from public enterprises (DF 374 million). **The expenditure measures included** a 60 percent reduction in the benefits paid to all employees on the budget payroll (DF 380 million); and a cutback in outlays on goods and services (DF 30 million).

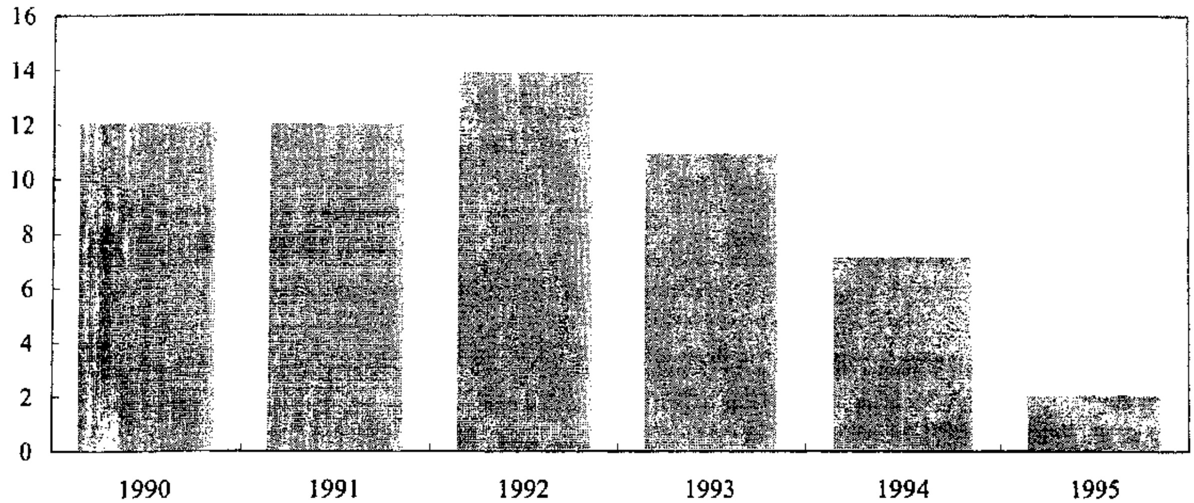
4. The overall objective was partially achieved as the fiscal deficit was cut by more than 4 percentage points of GDP in 1995. Revenue did not make any marked contribution because of the unfavorable economic environment characterized by a fall in activity in the transports, telecommunications, water, and electricity sectors.[1] By and large, the fiscal deficit adjustment, therefore, resulted from a sharp drop in expenditures on military and civilian goods and services, reflecting the cessation of hostilities and spending cuts imposed by

[1] The revenue measures remained broadly ineffective in the face of import compression and the closure of 100 bars, which negatively affected the collection of license revenue (shortfall of DF 300 million).

unpaid suppliers, as well as cost-saving administrative decisions adopted in the course of the year.[2]

Djibouti: Total Grants 1990–95

(In percent of GDP)



Sources: Djibouti Authorities; and Fund staff estimates.

5. Still, the deficit remained too large to be covered by external-financing in a context where external grants were dwindling.[3] Given the domestic financing constraints imposed by the currency board, and the depletion of the government's own deposits with commercial banks, the authorities resorted again to imposing large transfers from public enterprises, and a further accumulation of domestic and external arrears, thus raising the stock of arrears and domestic debt by end-1995 to an estimated total of DF 26.6 billion (30 percent of GDP). Furthermore, the structure of expenditures remained unbalanced, with wage outlays representing 24 percent of GDP while domestically-financed investment accounted for less than 1 percent of GDP.

[2] The decisions made in the context of the revised finance law included, inter alia, the suppression of two ministries (planning and port), the closure of three embassies (Brussels, Nairobi, and Tunis), the reduction in personnel in the remaining eleven embassies, and the cut back of 750 employees from the civil service.

[3] The main sources of budgetary support were France, the European Union, and the countries of the Gulf Cooperation Council (GCC). By 1994, France and Kuwait accounted for 80 percent of the total budgetary grants received. The drop in budgetary grants reflected, inter alia, a shift in French assistance policy in favor of countries embarking on comprehensive macroeconomic and structural reforms.

6. Aware of the prospects of a further decline in economic activity, unsustainable fiscal and external balances, harmful expenditure compression, and further accumulation of domestic and external arrears, the authorities opted to pursue their adjustment and reform efforts with the backing of adequate external financing. In this context, Djibouti embarked on medium-term reform programs, supported by the Fund, first under a Stand-By Arrangement (SBA), then under a Poverty Reduction and Growth Facility (PRGF) arrangement. The SBA and the PRGF arrangements aimed first at helping the authorities regain control of the fiscal situation in the short run and, secondly to implement medium-term, far-reaching reforms to address the deeply-rooted structural rigidities of the economy. In particular, the fiscal area, the main constraints that the authorities were facing included: (i) heavy staffing costs as well as military outlays inherited from the civil strife which took place from 1991 to 1994; (ii) the prevalence of excessive and nontransparent spending, because of weak spending management procedures; (iii) and a complex tax system weakened by an extensive web of tax and customs exemptions.

II. Further Fiscal Consolidation Under Fund Programs: 1996–2002

7. IMF financial assistance to Djibouti started on April 15, 1996, after the Executive Board approved an initial 14-month SBA, which was subsequently extended to a full three-year arrangement. Key elements of the strategy supported by the SBA included substantial financial policy tightening with emphasis on prompt budgetary adjustment and restructuring, and comprehensive structural reforms to improve external competitiveness and enhance the supply responsiveness of the economy. Djibouti made headway in reducing macroeconomic imbalances and introducing structural reforms in the fiscal area including, in particular, the downsizing of the civil service through demobilization. However, progress in restoring growth was limited as the recovery made possible by Ethiopia's decision in 1998 to channel its transit trade through the port of Djibouti was offset by cuts in French military assistance to the country. Consequently, the authorities adopted a successor medium-term program supported by a PRGF arrangement, which was approved on October 18, 1999. Together with macroeconomic stability, the PRGF-supported program aimed at implementing core structural reforms to reach higher growth rates, raise per capita income, and reduce unemployment. The envisaged reforms in the fiscal area included tax and revenue administration and public expenditure reforms; completion of military demobilization, implementation of a civil service retirement program; and reorientation of budget outlays toward social sectors.

Djibouti: Central Government Financial Operations, 1990–2002
(In percent of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Revenues and grants	37.9	37.7	40.4	39.6	36.5	31.1	30.6	31.0	34.2	30.9	31.0	28.2	29.4
Total revenue	25.8	25.6	26.4	28.7	29.3	29.1	28.8	27.2	25.4	23.5	24.4	23.3	23.5
Fiscal revenues	23.5	24.0	24.9	27.1	27.8	27.0	26.6	24.4	22.2	21.6	21.5	20.5	21.1
Direct taxes	8.0	8.3	8.2	8.4	8.9	10.8	11.8	10.7	9.9	8.9	8.9	9.1	9.3
Indirect taxes	15.5	15.8	16.8	18.7	18.9	16.2	14.8	13.8	12.3	12.7	12.5	11.4	11.7
Non tax receipts	2.3	1.6	1.5	1.6	1.5	2.1	2.2	2.8	3.2	1.8	2.9	2.8	2.4
Official grants	12.1	12.0	13.9	11.0	7.2	2.0	1.8	3.8	8.9	7.4	6.6	5.0	5.9
Total expenditure	45.2	40.6	51.8	52.6	47.6	39.8	34.5	35.3	33.3	33.1	32.8	29.7	32.9
Current expenditure	32.8	31.5	41.2	42.8	38.3	36.1	30.6	31.0	26.7	30.0	30.1	27.2	29.2
Wages and salaries 1/	18.8	18.6	23.3	24.3	24.0	24.2	20.8	22.0	16.4	15.4	14.9	14.5	14.0
Materials	9.3	8.3	11.3	11.5	6.6	7.4	4.8	4.9	4.6	6.8	6.1	4.6	6.2
Maintenance	0.0	1.2	0.8	0.7	0.7	0.5	0.5	0.5	0.3	0.4	0.7	0.5	0.6
Transfers	1.3	1.3	2.4	2.9	2.4	2.0	2.4	2.8	2.8	3.4	3.8	3.5	3.9
Interest	0.6	0.3	0.6	0.4	0.4	0.7	0.7	0.5	0.3	0.5	0.5	0.3	0.2
Foreign-financed development programs	...	...	...	...	...	...	...	...	2.3	3.3	4.1	3.8	3.6
Reinsertion program	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2
Other current spending	2.8	1.7	2.8	3.0	4.1	1.3	1.4	0.3	0.0	0.2	0.0	0.0	0.0
Incremental social programs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.7
Capital expenditure	12.5	9.1	10.6	9.8	9.3	3.7	3.9	4.3	6.7	3.1	2.7	2.5	3.7
Domestically-financed	1.5	2.1	2.1	1.1	1.2	0.8	0.5	0.7	0.3	0.4	0.5	2.0	0.6
Foreign-financed	11.0	7.0	8.5	8.7	8.1	2.8	3.4	3.6	6.4	2.6	2.1	1.0	3.2
Overall balance (payment-order basis, including grants)	-7.3	-3.0	-11.4	-13.0	-11.1	-8.6	-3.9	-4.3	0.9	-2.2	-1.8	-1.4	-3.5
Overall balance (payment-order basis, excluding grants)	-19.4	-15.0	-25.4	-23.9	-18.3	-10.7	-5.7	-8.1	-8.0	-9.6	-8.4	-6.4	-9.4
Change in arrears (cash payments = -)	5.2	-3.4	0.3	3.8	2.6	3.2	-0.7	2.4	-0.8	1.3	0.5	-0.6	-0.7
Overall balance (cash basis)	-2.1	-6.3	-11.1	-9.2	-8.5	-5.4	-4.6	-1.9	0.1	-0.8	-1.3	-2.0	-4.2
Financing	2.1	6.3	11.1	9.2	8.5	5.4	4.6	1.9	-0.1	0.8	1.3	2.0	4.2
Domestic financing	-2.6	4.6	9.4	5.9	5.7	3.8	1.2	0.5	-0.9	0.3	0.7	0.6	1.5
Bank financing	-2.6	-0.2	6.7	1.3	1.3	1.3	0.0	1.1	-0.8	0.3	0.7	0.6	1.5
Non bank financing	0.0	4.7	2.7	4.6	4.4	2.5	1.2	-0.7	0.0	0.0	0.0	0.0	0.0
External financing	4.7	1.7	1.7	3.3	2.8	1.6	3.3	1.4	0.7	0.5	0.6	1.4	2.7
Disbursements	6.6	2.6	2.0	3.7	3.2	2.0	3.5	1.9	1.6	0.9	1.0	1.8	3.3
Amortization payments 2/ 3/	-1.9	-0.9	-0.3	-0.4	-0.5	-0.4	-0.2	-0.4	-0.8	-0.4	-0.4	-0.4	-0.6
Memorandum items:													
Overall balance before grants (payment-order)	-19.4	-15.0	-25.4	-23.9	-18.3	-10.7	-5.7	-8.1	-8.0	-9.6	-8.4	-6.4	-9.4
Overall balance before grants (cash basis)	-14.1	-18.4	-25.0	-20.1	-15.7	-7.5	-6.4	-5.6	-8.7	-8.2	-7.9	-7.0	-10.1
Primary balance 4/	-5.6	-6.3	-14.1	-12.2	-6.1	-6.5	-0.9	-4.1	1.2	-2.6	-1.6	-0.3	-2.0

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

1/ Includes severance payments to military personnel being demobilized.

2/ Includes rescheduling of arrears on external debt payments as of end-October 1999 and external debt payments falling due during November 1, 1999 to June 2002.

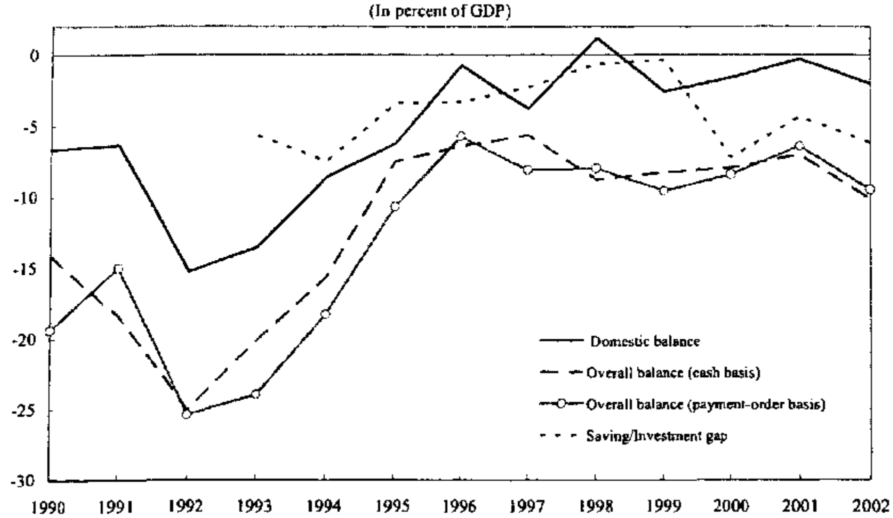
3/ Reflect bilateral debt cancellation (agreement signed in 1999).

4/ Total revenue (excluding grants) less total domestic-financed current and capital expenditures.

A. Magnitude

8. Reflecting continued efforts of fiscal adjustment, Djibouti was able to cut further the overall budgetary balance on a payment-order basis, including grants by 5 percentage points of GDP in 1996. The extent of the fiscal adjustment that year was of the same magnitude when measured in terms of domestic balance, which improved by 4.5 percentage points of GDP during the same period. While the reform programs contributed significantly to reducing government absorption, they were also instrumental in eliminating, since mid-2001, the sources of accumulation of domestic arrears and strengthening the capacity of the financial authorities to collect taxes and improve control over public spending so as to use them as effective tools for macroeconomic management.

Fiscal Indicators, 1990–2002
(In percent of GDP)

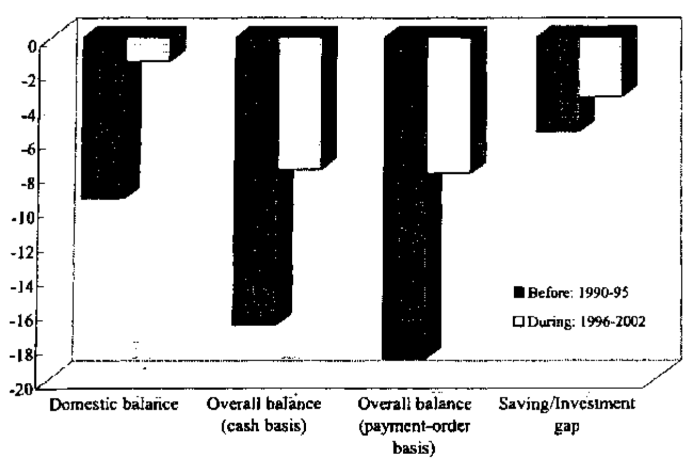


Sources: Djibouti authorities; and Fund staff estimates.

Distribution of the Fiscal Adjustment Effort

9. The most striking element of the second phase of fiscal adjustment has been the decline in revenue as a share of GDP (5.5 percentage points of GDP). Against this, the adjustment was achieved primarily through a strong expenditure compression (equivalent to 10 percent of GDP).

Fiscal Balances Before and During Two IMF Programs, 1990–2002
(Average period figures; in percent of GDP)



Sources: Djibouti authorities; and Fund staff estimates.

Revenue developments

10. By 1996, total revenue represented 29 percent of GDP, up from 25.8 percent of GDP in 1990, mainly reflecting the implementation of various measures aimed at covering the cost of the ethnic conflict (Table 1).[4] This high ratio reflected the full effect of past measures introduced to boost direct revenue—which accounted for 41 percent of total revenue—including (i) the maintenance of the patriotic tax, albeit at a lower rate (10 percent),[5] (ii) the rise in taxes on salaries, and (iii) a containment of tax evasion through the lowering of the threshold on profit taxation. At the same time, indirect taxes remained broadly unchanged at 15 percent of GDP, despite an adjustment to excise taxes on khat (see box), tobacco, and alcohol.[6]

11. From that peak, revenue declined steadily and remained, since 2000, in the range of 23–24 percent of GDP; this decline reflected increased tax exemptions (Table 2),[7] as well as tax fraud, fueled by lower taxes in neighboring countries and, most importantly, shortfalls in taxes on both wages and salaries (caused by the accumulation of arrears on wage and salary payments as well as the reduction in the French military forces), and on profits (resulting from the weak economic environment). To counter this slide in revenue, the government adopted various tax measures on income and consumption, further contributing to the complexity of the tax system.

12. In this context, Djibouti attempted, in 1997, to raise additional direct revenue through the closing of some loopholes by instituting (i) a minimum tax on profits of all enterprises; (ii) eliminating the deduction of the business lump-sum tax from taxable profits while extending it to all firms; and (iii) taxing salaries and benefits in kind. Furthermore, the business tax ***(patente)*** was raised. Pursuing its efforts to extend the tax base, Djibouti put in place a progressive tax on property in 1997, the rate of which was lowered a year later from 10 to 8 percent. New measures in 1999 abolished the real estate tax bracket for property used for professional purposes. On the consumption side, unlike many countries, Djibouti has no custom duties. The second pillar of the system is on a general consumption tax and on an extended set of excise tax. All excise taxes are now ad valorem, except cigarettes, on which a specific tax has been applied since 1997.

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[4] The ratio revenue and grants to GDP declined by almost 7 percentage points between 1990 and 1995 (down from 37.9 percent of GDP in 1990), and subsequently remained broadly unchanged as the grants portion rose from 2 percent of GDP in 1995 to 7 percent of GDP by 2002.

[5] The patriotic tax was raised to 15 percent of all salaries in 1994.

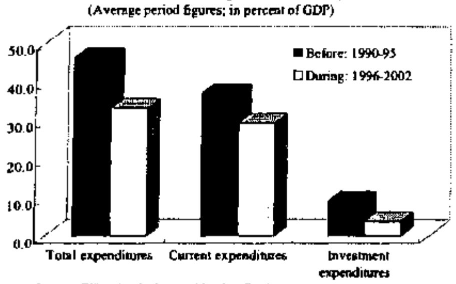
[6] These excise taxes represent on average 12 percent of total revenue.

[7] The government resorted to establishing a web of generous exemptions in the tax system to attract private investment; this ultimately contributed to a significant erosion of the tax base without much impact on the investment side. Excluding those granted to the French army, exemptions represented on average DF 8.5 billion ($48 million) per year.

13. That same year, the reference value for the taxation of khat was increased from DF 550 to DF 750 per kilo. It was again adjusted upward in 2001 to DF 851 per kilo. The introduction of all these measures was guided solely by the need to offset revenue losses and was not framed in the context of a consistent and comprehensive reform of the tax system. Furthermore, in the process, there has been little shift in the tax structure: direct taxes (mainly on corporate and personal income and salaries) still account for 40 percent of total tax revenue while indirect taxes account for 60 percent.

Expenditure developments

Expenditure Structure Before and During Two IMF Programs, 1990- 2002 1/
(Average period figures; in percent of GDP)



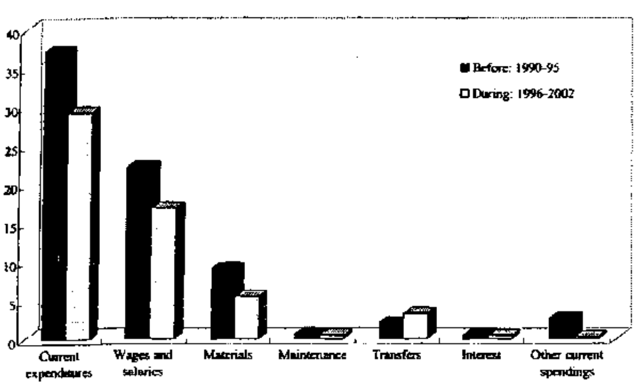
Sources: Djibouti authorities; and Fund staff estimates.

1/ First program was supported by a stand-by arrangement (1996-1998), the second program was supported by a PRGF arrangement (October 1999-January 2003).

14. Between 1996 and 2002, budgetary expenditures declined by almost 10 percentage points of GDP. This significant reduction resulted from the implementation of a set of corrective policy measures aimed at bringing down outlays in line with available resources but also at improving the quality of public expenditure management and changing the level and structure of expenditures. These measures included a tightening of income policy over the years, strengthening of budgetary execution, containing non-essential outlays and improving prioritization as well as better targeting of needs.

15. Current expenditures, excluding foreign-financed items, declined by 5 percentage points from 1996 to 2002. At the same time, the structure of current spending was altered as evidenced by the decline in the wage bill, which fell from 21 percent of GDP in 1996, to 14 percent of GDP in 2002, in response to several policy measures. First, benefits and salaries of embassy personnel were cut in 1996; a year later all salaries were frozen. Finally, nominal salaries were cut by 10 percent in 1998. That same year, the decision was made to freeze hiring in the civil service except for social sectors. Eligible civil servants retired without being replaced—albeit with some delays due to a lack of funds to cover the costs of departures—and a significant share of the military personnel hired during the conflict was demobilized. Spending on materials was also lowered as a result of better targeting of needs and better procurement procedures. The resulting savings helped the authorities increase social outlays such as transfers to households, private charities, and for education purposes like scholarships, which represented

Current Expenditure Structure
Before and During Two IMF Programs, 1990- 2002
(Average period figures; in percent of GDP)



Sources: Djibouti authorities; and Fund staff estimates.

3.9 percent of GDP by end-2002, up from 2.4 percent of GDP in 1996. Maintenance spending remained broadly unchanged at almost 1 percent of GDP over the years.

The Use of Khat

Khat is a leafy narcotic which produces feelings of euphoria and stimulation due to its chemical composition, which is close to that of an amphetamine. In ancient times, khat was chewed by Muslims in lieu of drinking alcohol, and physicians prescribed it to soldiers to reduce fatigue. Historians argue that khat chewing started in the southern Red Sea region prior to the fourteenth century. Khat has become a cultural phenomenon in Djibouti. Until 20 years ago, khat chewing was mainly consumed by wealthy people during the weekend. Today, khat is chewed several days a week by a large share of Djibouti's population. The consumption of this leaf is a social event and participants in khat sessions view time spent chewing it as productive time, helping to conduct and conclude business deals, reinforce communication, and improve verbal skills. In Djibouti, workdays end about 1:00 p.m., and very few government agencies resume work in the afternoon. The khat consumed in Djibouti is imported from Ethiopia, and is known to be of good quality due to the "loose volcanic soil" found in that country.

Khat sessions

No food is served while khat is chewed; only water is consumed to help wash the leaves' juice into the system. Between 100 and 200 grams of leaves are chewed over three or four hours. The leaves are placed in the mouth and held between the molars and the cheek. Stimulation from khat chewing can occur within 15 minutes of chewing. Tea with milk is often served at the end of the khat session. By filling the mouth to capacity with fresh leaves, the user then chews intermittently to release the active components. Chewing khat leaves produces a strong aroma and generates intense thirst. Casual users claim khat lifts spirits, sharpens thinking, and, when its effects wear off, generates mild lapses of depression similar to those experienced by cocaine users.

16. With expenditure patterns similar to those of many developing states, spending in Djibouti tends to favor current rather than capital outlays. The latter remained unchanged at 4 percent of GDP in 1996 and 2002, reflecting mainly the volatility of project support from foreign donors and creditors. During the same period, the domestically-financed component of capital outlays also remained unchanged at 0.5 percent of GDP.

17. An important development has been the reversal of the trend of accumulation of domestic payments arrears.[8] As indicated earlier, significant domestic payment arrears had been accumulated throughout the 1990s, and even in 1999 and 2000 (the first years of the PRGF arrangement); such arrears reflected weak spending procedures and revenue shortfalls.

[8] Relating to civil servants' salaries, pension funds, private suppliers, and public enterprises.

18. By end-2000, they amounted to DF 29 billion (Figure 5).[9] To address this complex issue and restore the financial credibility of the government, Djibouti adopted a three-pronged strategy aimed first at bringing spending in line with available resources through a rigorous implementation of a treasury cash management plan; secondly, launching, with external support, an audit of the stock of domestic arrears, on the basis of which a comprehensive plan to gradually clear them was adopted; and finally, strengthening expenditure management procedures through an ambitious reform of the entire budgetary process.

Government Domestic Payment Arrears, 1992- 2002
(In percent of GDP)

Sources: Djibouti Authorities, and Fund staff estimates.

19. To reverse the trend of accumulated arrears and offset, at the same time, the fiscal slippages recorded by end-2000, Djibouti introduced in April 2001 a drastic cash flow plan, aimed mainly at maintaining monthly spending in line with projected revenue. The successful implementation of the cash flow plan was predicated on key conditions, including the following (i) the building of a consensus among line ministries for strict adherence to the cash flow plan objectives; (ii) the need to strictly observe prioritization retained in the cash flow plan; and (iii) the ministry of finance being in a decision-making position regarding non priority spending. Regarding the first condition, the authorities adopted the cash flow plan by presidential decree on May 23, 2001, providing a legal foundation for, as well as a political backup to, the new treasury instrument. With respect to the second condition, the decision was made not to roll over the next month's uncommitted spending in the current period. Finally, to strengthen implementation of this plan, it was agreed that the ministry of finance would retain authority over the amount of non priority spending that can be committed each month by line ministries. A government cash flow management commission[10] was set up, under the chairmanship of the prime minister's

[9] With support from the European Union and the World Bank, the authorities conducted a comprehensive inventory of all domestic payment arrears accumulated since 1996. The authorities indicated that they were not in a position to push back the cutoff-date for the survey because records were destroyed by the flooding of the treasury directorate in the mid-1990s.

[10] This commission included the director of finance, budgetary control treasury, and revenue, as well as representatives of the prime minister's office. Day to day cash flow plan monitoring activities were carried out by a technical committee made up of the deputy directors of finance, budgetary control, accounting, and the head of the treasury's research and programming unit.

chief of staff to design, monitor, and implement this plan. The cash flow plan was engineered on the basis of the budget.

20. With the strengthening of the budgetary process by late 2000, and rigorous implementation of the treasury cash management plan since April 2001, Djibouti was successful in bringing government spending in line with available resources, thus triggering, for the first time in years, a decline in the outstanding stock of arrears (estimated at 27.8 percent of GDP by end-2002). Furthermore, aware that they were a major constraint in the face of economic revival, the authorities adopted by end-2002 a comprehensive plan to gradually clear all validated domestic payment arrears.

DJIBOUTI—PLANNED FISCAL MEASURES, 1996–2002

Year	Planned Fiscal Measures	
	Revenue	**Spending**
1996 Budget	• Enlarging the profit tax base by lowering the threshold of taxation. • Increasing the tax rate on wages and salaries exceeding DF 25,000; and widening the tax base through inclusion of all wage-related benefits in kind. • Increasing the reference value for the taxation of khat from DF 550 to DF 750 per kilo. • Replacing the ad valorem tax by a specific tax on cigarettes. • Introducing a 5 percent tax on registration. • Raising nontax revenue, reflecting public enterprises' reimbursement of earlier on lending by the government of proceeds of external debt that was canceled; the differential between the administered and import prices of oil products; and the proceeds of sales of real estate. The main revenue-reducing measures (loss of 1.8 percent of GDP) were the following: • Reducing the patriotic contribution rate from 15 percent of GDP to 10 percent (the level prevailing before October 1995) for all wage earners except for government employees, for whom it was replaced by an equivalent salary withholding. • Lowering the consumption tax on a number of basic products.	• Reducing the wage bill (by 4.5 percent of GDP) through: (i) elimination of irregularities in employment and cash allowances survey; (ii) withholding of 10 percent on all salaries, wages, and related benefits exceeding DF 60,000; (iii) cutback in benefits and salaries of embassy personnel; and (iv) elimination of overtime. • Cutting expenditure on materials and supplies through: control of consumption of utilities and phased elimination of housing rental payments by the government, to be based on the results of the March 1996 survey of housing allowances. • Lowering maintenance and transfer outlays. • The savings was to be partially offset by increases (0.6 percent of GDP) in recruitment for education and health sectors; other PIP-related current expenditures; and in capital outlays.
• 1997 Budget	The new tax measures implemented in 1997 include mainly: • Implementing a 5 percent tax on food stuffs. • Implementing a minimum tax of 3 percent on all inputs exempted under the investment code and/or financed through external assistance (0.1 percent of GDP). • Implementing an excise of DF 14 per liter on locally-produced soft drinks (0.2 percent of GDP). • Increasing the domestic consumption tax applicable to a few imported luxury goods and elimination of the zero tax rate (0.1 percent of GDP). • Imposing a minimum tax on profits of all enterprises (0.1 percent of GDP). • Introducing a progressive tax on income from property (0.1 percent of GDP). • Eliminating the deductibility of the business minimum lump sum profit tax and extension of this tax to all enterprises (0.05 percent of GDP). • Taxing wages paid in kind (0.05 percent). • Improving collection of income taxes and the patriotic contribution (0.1 percent of GDP). • Broadening the tax base for patents and other licenses (0.1 percent of GDP).	The fiscal measures for controlling and reducing current expenditures that were implemented in 1997 aimed at generating savings through a reduction in the wage bill and continued strict control of other current expenditures. The wage bill measures include: • A freeze on wages (DF 918 million or 1.0 percent of GDP). • Eliminating free housing and transport allowances (DF 272 million and DF 47 million, respectively, or 0.4 percent of GDP in total). • Job attrition (by not replacing jobs vacated by retirees) (DF 32 million of 0.04 percent of GDP). • Reaching savings equivalent to three months' wages on account of the 2,113 persons expected to be demobilized during the final quarter of 1997 (DF 189 million or 0.2 percent of GDP).

	• Intensifying the revenue collection efforts begun in 1996 and enforcing compliance with tax legislation, focusing on taxes on corporate profits and on certain consumption taxes.	
• 1998 Budget	• Reducing rate of patriotic contribution from 10 to 8 percent. • Eliminating the 3 percent tax on foreign-financed project inputs. • Reducing property tax from 10 to 8 percent. • Lowering of consumption tax on luxuries from 44 to 33 percent. • Revenue loss on tax on wages and salaries due to cut in wage bill.	• Cut in nominal salaries of over DF 80,000 per month by 10 percent. • Eliminating retirees' posts. • Recruiting additional staff for basic education, health, and justice. • Eliminating overtime. • Reducing selected family allowances. • Reducing embassy expenses. • Eliminating expenditure without authorization. • Reducing expenditures on materials and supplies, maintenance, and transfers. • Increasing capital expenditures.
1999 Budget	• Reducing rate of consumption tax on clothing, shoes, construction materials, and machines from 33 percent to 20 percent (-0.2 percent of GDP). • Eliminating exemptions (0.1 percent of GDP) by (i) introducing a 15 percent consumption tax on products from industrial processing zone sold in domestic market, (ii) introducing a 5 percent tax for smallholder and occasional businesses "charcharis," and (iii) abolishing the real estate tax bracket for professional property values. • Introducing user fees in transit area (DF 4,000 per container and DF 200 per ton for bulk goods) (0.1 percent of GDP). • Rationalizing tax administration by (i) revising license fee system and harmonizing corporate and import license fees with the latter being based on import values; and (ii) clarifying the taxation of benefits in kind at the same rate as other individual incomes.	• Continuing wage freeze (-0.3 percent of GDP), reducing number of employees (212 persons, -0.4 percent of GDP), and recruiting new personnel (79 persons in education, 64 persons in health, 6 persons in justice and administration. • Increasing outlays for materials and supplies to cover adequately utilities and administrative expenditures. • Increasing maintenance allowances. • Increasing transfers to social sectors (education and health: 0.4 percent of GDP). • Increasing capital expenditure in line with available foreign financing and absorptive capacity of Djibouti (0.4 percent of GDP). • Completing demobilization program (net cost: 0.4 percent of GDP): (i) severance pay (0.9 percent of GDP); and (ii) savings (-0.5 percent of GDP). • Implementing the reinsertion program (0.6 percent of GDP).

2000 Budget	• Doubling excise tax on tobacco. • Increasing corporate taxes on businesses engaged in transit trade.	Reduction in the wage bill through: • Demobilization. • Freezing the total number of government staff (except for the education and health sectors). • Freezing the total nominal wage bill that was introduced with the 1998 budget. • Early mandatory retirement of certain high-salaried police and military personnel. • Enforcing regular and overdue retirements.
2001 Budget		• Reducing the wage bill to 14.6 percent of GDP, a 0.3 percentage point reduction from its 2000 level, mainly through demobilization and retirement of eligible staff. • Reducing expenditure on goods and services to 4.8 percent of GDP through the discontinuation of the procedure allowing spending without prior order payments, the elimination of the compensations operations, and stricter control of consumption of utilities.
2001 Revised Budget	• Inclusion in the budget of specific increases on khat, tobacco, and alcohol implemented in February 2000 to finance non-budgeted efforts to promote peace to Somalia. • Increasing the port's dividend payment to the budget. • Inclusion in the budget of newly-agreed rental payments on French military housing. • Increasing the provision for strengthened tax collection on wage and property in incomes based on the incomes through March 2000.	• Furthering expenditure savings totaling 0.7 percent of GDP. • Cutting, by 0.1 percent of GDP, military materials. • Accelerating debt obligation plan. • Reducing transfers, by 0.1 percent of GDP, through cuts in student grants.
2002 Budget	• Increasing dividend payment from the port. • Tax provisions on national production in line with the requirements of COMESA. • Transferring the tax collection subdirectorate from the treasury directorate to the revenue directorate to make the tax collection administration more efficient. • Taxing services expected to yield about DF 0.7 billion (0.6 percent of GDP). The initial 2002 budget aimed at raising total revenue by 0.7 percent of GDP and lowering domestically-financed expenditure by 1.1 percentage point of GDP through a reduction of the wage bill. The domestic balance was expected to shift into a surplus equivalent to 1.6 percent of GDP.	• Lowering the wage bill through the demobilization of 2,000 soldiers and security agents as well as the retirement of 800 eligible civil servants in early 2002. At the same time, 170 new staff were hired to cover some staffing needs in the education, health, and justice sectors. • A moderate increase in spending on materials and maintenance to a more realistic level.

	On the revenue side, in addition to the full effect of policies introduced in 2001, additional measures to increase revenue by about DF 900 million (0.9 percent of GDP) included: • An increase in specific taxes on oil products. • An extension of the consumption tax to spare tires sold in the port zone to Ethiopian truck owners. • A new methodology to compute the surtax on khat. • A new stamp tax on all transactions conducted by public enterprises. • A new campaign to extend the number of paying tax payers.	