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Union of the Comoros: 2006 Article IV Consultation and Fourth Staff Review and Extension of the Staff-Monitored Program—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Union of the Comoros

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the combined discussion of the 2006 Article IV consultation with the Union of the Comoros and fourth staff review and extension of the Staff-Monitored Program, the following documents have been released and are included in this package:

- the staff report for the combined 2006 Article IV Consultation and Fourth Staff Review and Extension of the Staff-Monitored Program, prepared by a staff team of the IMF, following discussions that ended on July 26, 2006, with the officials of the Union of the Comoros on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 27, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;

- a staff supplement of September 27, 2006 containing annexes to the staff report;

- a Public Information Notice, summarizing the views of the Executive Board as expressed during its October 13, 2006, discussion of the staff report that concluded the Article IV consultation; and

- a statement by the authorities of the Union of the Comoros.

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

Letter of Intent sent to the IMF by the authorities of Union of the Comoros*
Memorandum of Economic and Financial Policies by the authorities of
Union of the Comoros*
Selected Issues Paper and Statistical Appendix
*Are also included in the Staff Report

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

UNION OF THE COMOROS

Staff Report for the 2006 Article IV Consultation and Fourth Staff Review and Extension of the Staff-Monitored Program

Prepared by the African Department

(In consultation with other departments)

Approved by Thomas Krueger and Anthony Boote

September 27, 2006

Objectives: A mission visited Comoros July 12-26, 2006, to conduct the 2006 Article IV discussions and review performance under the Staff-Monitored Program (SMP).

Country representatives: A new administration took office in late May 2006, after President Sambi was elected in the first democratic power transfer in over a decade. The mission met with finance minister Hamadi, central bank governor Abdoulbastoi, and representatives from the Union and island governments, parliament, the private sector, trade associations, the international community, and the media. The mission was received by President Sambi and the three island presidents.

Mission team: The mission team comprised Mr. Mumssen (head), Ms. Al-Zein, Mr. Baldini, Mr. Lopes, and Ms. Ocampos (all AFR). It was joined by a representative of the African Development Bank. The IMF Resident Representative for Madagascar, Mr. van den Boogaerde, assisted the mission.

Article IV consultation: The Article IV discussions focused on medium-term challenges: external sustainability, fiscal institutions, and private sector development. Previous consultations have emphasized the need to strengthen interisland fiscal cooperation, develop the financial sector, and accelerate structural reforms. Implementation of past advice has been hampered by political tensions, weak capacity, and low technical assistance.

Selected Issues and Statistical Appendix Paper: Two chapters examine (i) the role of remittances and (ii) the experience with fiscal decentralization.

Staff-Monitored Program: Fiscal performance under the SMP went off track in the pre-election period. The SMP was extended through December 2006 (see Letter of Intent, Attachment I), with the aim of restoring revenue collection and unwinding arrears.

Article VIII: Comoros has accepted the obligations under Article VIII, Sections 2, 3, and 4, and has no restrictions on payments for current international transactions.

Data: Lack of reliable statistical data continues to hamper surveillance (see Statistical Issues Annex). The mission helped the authorities to improve the historical series for national accounts and the balance of payments. The authorities have requested technical assistance on statistics.

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EXECUTIVE SUMMARY

The May 2006 presidential elections were a milestone in the national reconciliation process. After decades of political turmoil and interisland tensions, Comoros has gradually stabilized since a new constitution was introduced in 2001. The elections resulted in the first democratic power transfer in over a decade; President Ahmed Sambi scored a landslide victory with his message of political change, commitment to the rule of law, and a promise of higher living standards.

The Article IV discussions focused on medium-term policy challenges. There was broad agreement on policy priorities, based on the Interim Poverty Reduction and Growth Strategy Paper's (I-PRSP, EBD/06/51) vision for raising economic growth and improving social conditions. Its implementation will require higher foreign aid and policy measures to:

- move toward external sustainability through arrears clearance, HIPC and MDRI debt relief, higher external assistance, and domestic policy adjustments to improve external competitiveness;

- support private sector growth and economic diversification, through structural reforms aimed at developing the financial sector, improving the investment climate, simplifying tax laws, liberalizing trade, and enhancing competition and private sector involvement in energy, telecommunications, and transportation; and

- enhance the capacity of fiscal institutions, by intensifying interisland coordination and by strengthening revenue administration, budget execution monitoring, and economic statistics.

SMP discussions focused on steps to remedy the sharp deterioration in public finances that occurred in the pre-election period. The new government has moved quickly to investigate pre-election corruption, strengthen governance in public administration and enterprises, and restore interisland cooperation in fiscal matters. Near-term policy objectives—to be monitored under an extension of the SMP through December 2006—are to restore fiscal revenue collection, curtail spending, unwind wage arrears, and restart structural reforms. Measures to boost revenues and contain spending were incorporated into a supplementary budget approved by Parliament in August.

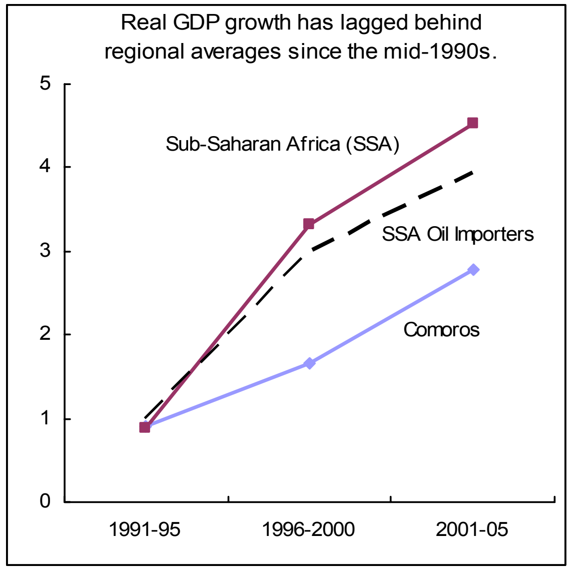
The authorities attach high priority to a PRGF arrangement, which they see as critical for anchoring their reform program, unlocking donor support, and obtaining debt relief under the enhanced HIPC initiative and MDRI. They expressed their hope to conclude negotiations on such an arrangement as soon as possible. This will require satisfactory performance under the extended SMP and understandings with official creditors on mechanisms to clear the country's substantial external arrears.

I. Article IV Consultation

A. Economic Retrospective

A poor growth record

1. **Economic growth has been weak and narrowly based for decades.** The economic upturn recorded in most of sub-Saharan Africa since the mid-1990s has been much less pronounced in Comoros. Real GDP growth averaged 2¾ percent for 2001-05, well below the regional average. Per capita, real GDP has declined by an estimated ½-percentage point per year over the past two decades. Economic activity is largely confined to subsistence agriculture, production of three export crops (vanilla, cloves, and ylang-ylang), import-related commerce, and government services. Fishing and tourism are well below potential. Manufacturing is almost nonexistent.

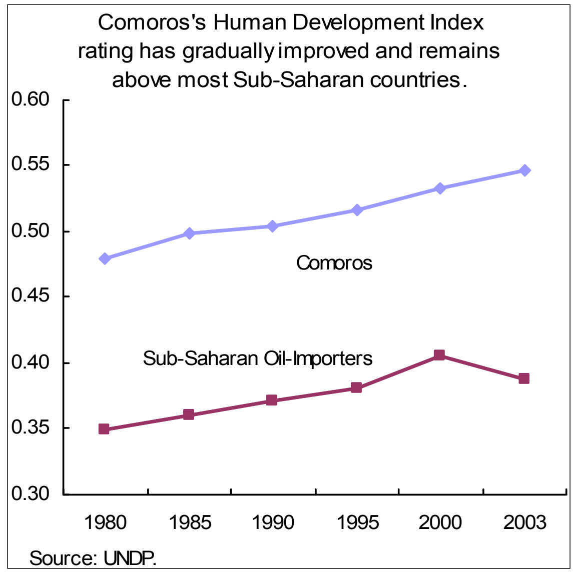


2. **The poor growth record partly reflects the country's inherent disadvantages,** including (i) the small size of the local market, which limits economies of scale and competition; (ii) very high transport costs and few air links, constraining trade and tourism; and (iii) environmental factors, including high population density, deforestation, scarcity of fresh water, and occasional volcanic eruptions.

3. **Political instability and external shocks have also played a detrimental role.** Years of interisland tensions, culminating in the 1997-2001 secessionist crisis, have undermined institutional capacity and led to a sharp reduction in donor assistance. The narrow export base has exposed the economy to international price swings, as underscored by the recent plunge in vanilla prices.

4. **Private sector development has been held back by a poor business environment, inadequate infrastructure, and an underdeveloped financial sector.** In the World Bank's 2006 *Doing Business* Survey, Comoros ranked 144th worldwide and 22nd out of 45 sub-Saharan African countries. Foreign direct investment (FDI) has been deterred by weak contract enforcement, high transport costs, the small local market, and poor telecommunication and utility services. The lack of foreign investors has in turn limited competition, innovation, transfer of know-how, and linkages to export markets. The largest employers are the government and the public infrastructure monopolies. Access to credit from the only commercial bank is largely limited to short-term trade financing.

5. **Almost half the population lives in poverty, although social indicators are more favorable than in most of sub-Saharan Africa.** This is partly because Comoros has one of the lowest rates of HIV/AIDS in the region. It has therefore not seen the setbacks in life expectancy and infant mortality observed in most of sub-Saharan Africa. Comoros ranks 8th among countries in sub-Saharan Africa on the UN's Human Development Index (2005), following decades of slow but steady gains. Achieving the Millennium Development Goals (MDGs) would require not only an increase in economic growth and external assistance but also continued efforts to keep HIV/AIDS under control.



Social indicators are more favorable than regional averages, but poverty is widespread and the MDGs are a distant prospect.

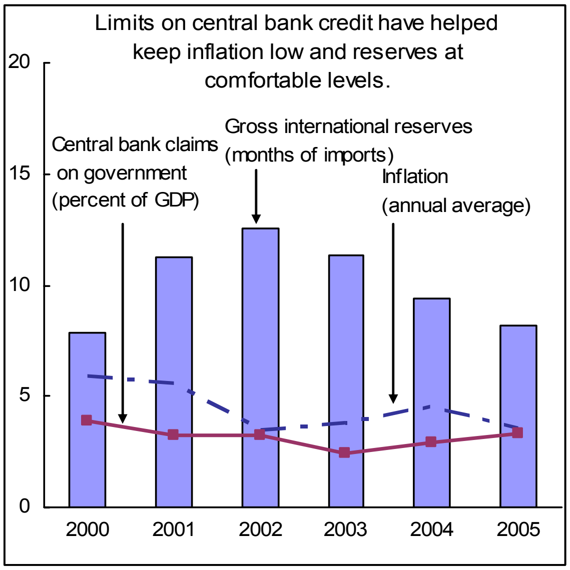
	Comoros	(year)	Sub-Saharan Africa average	(year)	MDG target for 2015
GDP per capita (U.S. dollars)	633.0	(2005)	536.9	(2004)	...
Poverty rate (in percent of population)	44.8	(2004)	44.0	(2003)	(reduce by 1/2 from 50)
Life expectancy at birth (years)	62.9	(2004)	46.2	(2004)	...
Infant mortality rate (per 1,000 live births)	59.0	(2002)	100.5	(2004)	40.0
Lack of access to safe water (in percent of population)	6.0	(2002)	42.0	(2003)	(reduce by 1/2 from 7)
Education					
Net primary enrollment ratio (percent of relevant age group)	54.7	(2001)	64.1	(2003)	100.0
Ratio of girls to boys in primary and secondary education (percent)	82.4	(2001)	83.6	(2004)	100.0
Health					
Prevalence of child malnutrition (percent of children under 5)	26.0	(2002)	...		9.3
Maternal mortality ratio (modeled estimate, per 100,000 live births)	480.0	(2001)	920.9	(2000)	(reduce by 3/4 from 381)
Immunization rate (DPT, percent of children under 12 months)	76.0	(2004)	63.9	(2004)	100.0
HIV/AIDS infection (percent of population aged 15-49)	0.3	(2003)	7.0	(2004)	0.3 (halt rate of spread)

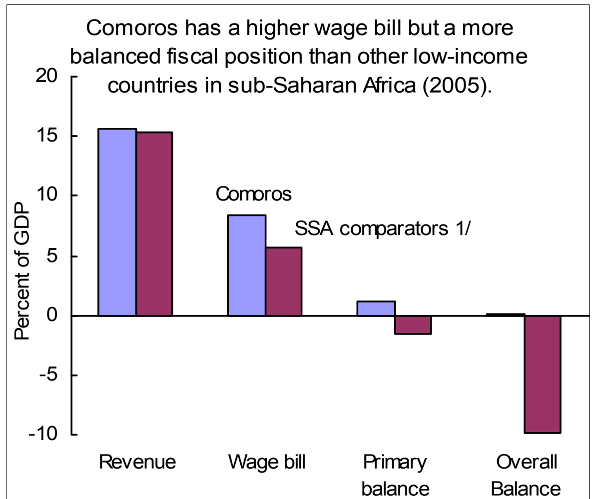
Sources: Comorian authorities, World Bank; *World Development Indicators*.

Macroeconomic stability but a lack of flexibility

6. **Membership in the franc zone arrangement has been the economy's anchor of stability.** Comoros has maintained an exchange rate peg with France, its largest trading partner, since the colonial era. The Comorian franc was devalued once, by 33 percent in 1994, when other franc zone countries devalued by 50 percent. The hard peg and the

safeguards of the franc zone arrangement have kept annual inflation since 1995 in the range of 1-6 percent and international reserves at comfortable levels. The arrangement has also provided some discipline for fiscal policy, capping the stock of central bank credit to government at 20 percent of fiscal revenues. Monetary policy is mostly passive, constrained by the franc zone framework and the underdeveloped local financial sector.





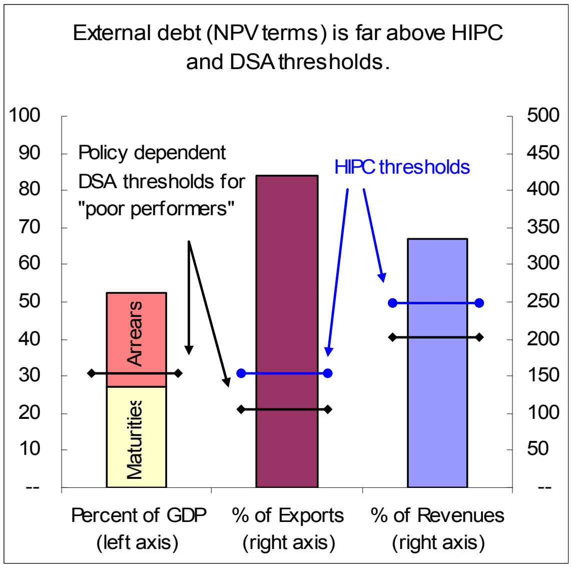
1/ Unweighted average. Includes SSA countries with GDP per capita below $700 and no major natural resource revenue.

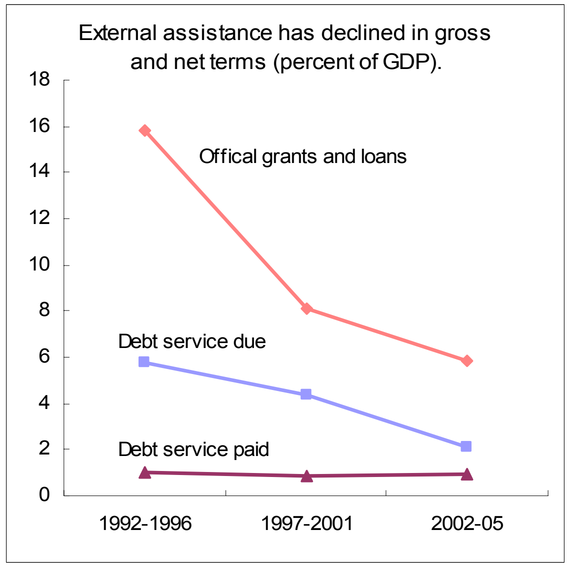
7. **Fiscal policy has been severely constrained by a large wage bill and lack of access to domestic financing.** While the revenue-to-GDP ratio is broadly in line with the regional average, weak expenditure control in the context of fiscal decentralization has pushed up the public wage bill. Lack of domestic and external financing have kept fiscal deficits low, but it has also limited social spending and public investment. The tight fiscal envelope and inadequate institutional capacity have contributed to chronic arrears accumulation.

Excessive debt and limited external assistance

8. **External debt has been well above the HIPC threshold for over two decades.** With large-scale borrowing from official creditors after independence, external debt accumulated rapidly, reaching 100 percent of GDP by the mid-1980s. At end-2005, the net present value (NPV) of debt amounted to an estimated 419 percent of exports of goods and services, and arrears accounted for almost half of it. In recent years, debt service has been paid in full to the World Bank, whereas arrears have continued to accumulate to other official creditors. Comoros does not have debt to the IMF.

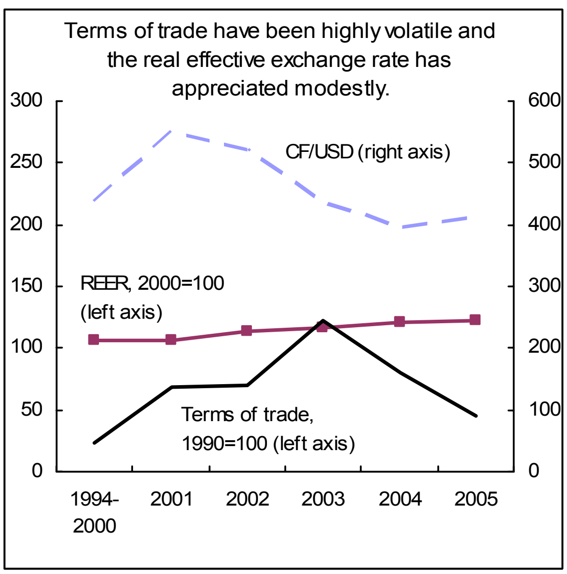
9. **External assistance collapsed during the 1997-2001 secessionist crisis, and has not yet recovered.** Low levels of aid also reflect unresolved external arrears and lack of adequate monitoring and control of budget execution. The low level of technical assistance has in turn prevented progress in rehabilitating institutional capacity.

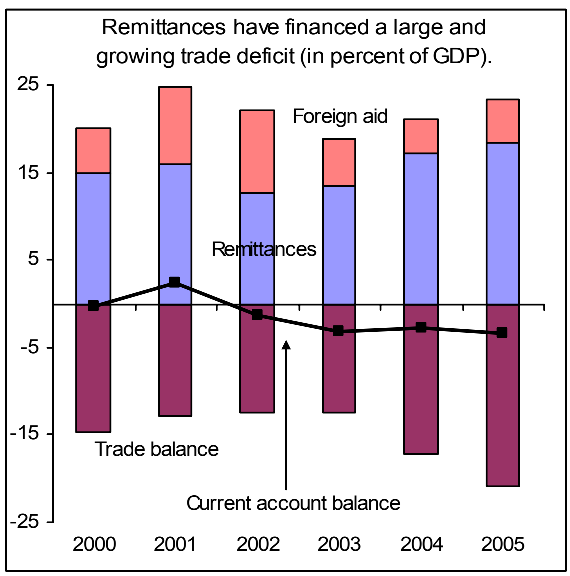




Exposure to external shocks

10. **Comoros' terms of trade have fluctuated widely and are now about 10 percent below their ten-year average.** International vanilla prices skyrocketed during 2001-03 and collapsed thereafter, reflecting supply conditions in Madagascar and fluctuating global demand. Rising oil prices have further weakened the terms of trade. The real effective exchange rate in 2005 was about 12 percent above its ten-year average, partly because the euro has been gradually appreciating against the U.S. dollar since 2000.





11. **Remittances have offset a large trade deficit and provided a buffer against external shocks** (see Selected Issues, Chapter I). Emigrant remittances to Comoros are among the highest in the world, averaging 15½ percent of GDP and 49 percent of all current

account receipts during 2001-05. They have mainly been used for imports of consumer products, resulting in a large structural trade deficit. They also helped offset the 2004/05 terms of trade shock and the associated deterioration in the trade balance, keeping the current account deficit relatively modest.

Recent developments and short-term outlook

12. **The May 2006 presidential elections were a milestone in the national reconciliation process.** They resulted in the first democratic power transfers in over a decade and rotation of the Union presidency to a native of Anjouan island. The new president, Ahmed Sambi, scored a landslide victory with his message of political change, commitment to the rule of law, and a promise of higher living standards. He appointed a new Union government in late May. The three islands of Grande Comore, Anjouan, and Moheli will hold island presidential elections in the spring of 2007.

13. **After stabilization gains in 2005, economic performance worsened in 2006.** Higher tourism and services in 2005 helped speed economic growth, and fiscal performance improved, with a sharply higher primary fiscal balance and a net reduction in domestic expenditure arrears. For 2006, real GDP growth is projected to decline to 1¼ percent, due to the continued weakening of agriculture, resulting from low international vanilla prices, and sharply lower tourism, resulting from the closure of a major hotel. The economic slowdown is mirrored in declines in broad money and credit to the private sector. Given low demand for domestic goods, inflation is expected to remain moderate despite higher fuel prices. A further decline in exports and strong import growth (due to fiscal loosening and higher remittances) are likely to widen the current account deficit and reduce international reserves. Public finances deteriorated sharply during the pre-election period, and the new government has since taken steps to boost revenue and cut expenditure (see SMP discussions, Section II).

Comoros: Selected Economic Indicators, 2004-07

	2004	2005	2006		2007
	Est.		Orig. Prog.	Revised	Proj.
Real GDP growth (in percent)	-0.2	4.2	2.5	1.2	3.0
Average annual inflation (in percent)	4.5	3.6	4.2	3.8	3.0
Domestic revenue (in percent of GDP)	15.6	15.7	15.2	14.2	15.7
Domestic primary balance (in percent of GDP)	-0.5	1.1	0.9	-0.3	1.0
Current account balance (in percent of GDP)	-2.8	-3.3	-3.8	-4.5	-6.0
International reserves (months of imports of goods and services)	9.4	8.2	9.4	7.3	6.1
Terms of trade (annual percentage change)	-34.2	-43.9	6.6	-6.0	...
Official grants and loans (in percent of GDP)	3.8	5.0	6.7	7.9	9.0
External debt (NPV in percent of exports of goods and services)	...	419.4	...	493.2	...

Sources: Comorian authorities and Fund staff estimates and projections.

B. Medium-term Macroeconomic Framework

14. **The recently issued I-PRSP sets out a clear vision for combining private sector-led economic growth with improved social services.** As noted in the Joint Staff Advisory Note (EBD/06/52), the I-PRSP was prepared in what was for Comoros an unprecedented participatory process and served as the reference framework for the December 2005 donor roundtable. It focuses on improvements to public finances, infrastructure, conditions for private sector development, governance, health, and education.

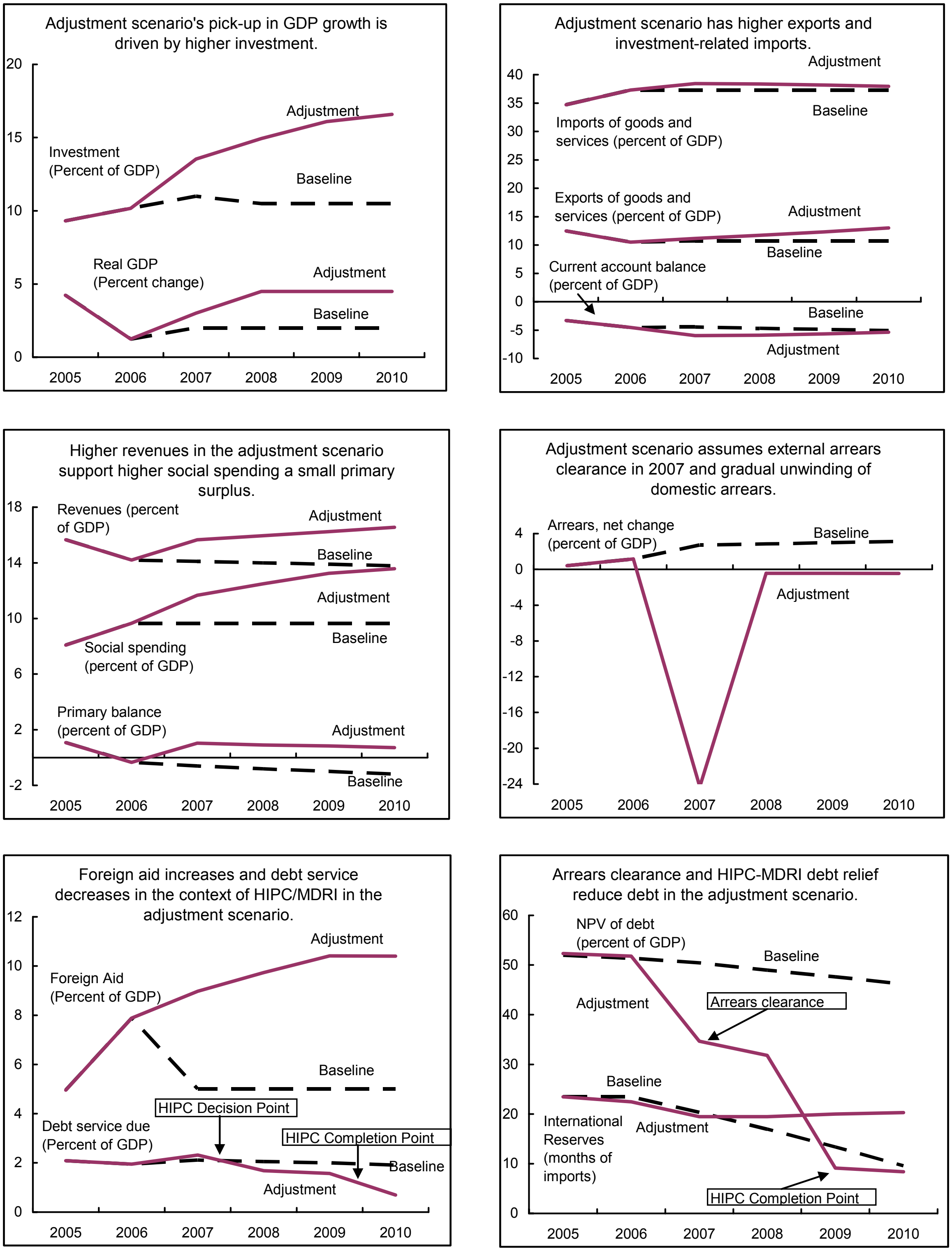
15. **The mission discussed with the authorities a medium-term macroeconomic framework** (Table 2). The reference point was a baseline scenario with unchanged policies and aid, and real GDP growth of 2 percent per year, in line with the ten-year historical average. Fiscal revenues and wages would remain broadly unchanged, preventing a pick-up in public investment and social spending. Domestic and external arrears would accumulate steadily and external debt would remain unsustainably high.

16. **An adjustment scenario was prepared to anchor the authorities' medium-term economic reform program.** The authorities believed that their program could help raise real GDP growth to 4 percent on average for 2007-09, supported by a pick-up in public and private investment. As in the I-PRSP, growth sectors are assumed to include tourism, agriculture, fishing, finance, infrastructure, and communication. A rebound in exports would limit the increase in the trade deficit caused by higher aid-related imports (Table 2).

17. **The adjustment scenario allows for higher social spending and public investment while minimizing new debt and reducing arrears.** A primary surplus of about 1 percent of GDP would be targeted each year to allow for a modest amount of debt service and a gradual reduction in domestic arrears. Public investment and social spending could be raised by about 6 percentage points of GDP between 2006 and 2009, based on a gradual rise in domestic revenue, a modest reduction in the wage bill, and higher external assistance in line with pledges announced during the 2005 donor conference.

18. **The adjustment scenario assumes comprehensive debt relief under the HIPC Initiative and MDRI.** The staff estimates that the NPV of debt would decline to about 64 percent of exports by 2010, assuming: (i) arrears clearance and rescheduling on concessional terms in 2007, (ii) bilateral debt rescheduling for 2007–09, (iii) interim debt relief in 2008-09, and (iv) HIPC and MDRI debt relief in 2009. In 2007, debt service would be somewhat higher than in the baseline scenario, reflecting rescheduled arrears.

Comparison of Baseline and Adjustment Scenario, 2005–10



C. Medium-term Challenges

19. **Article IV discussions focused on three medium-term challenges critical for raising economic growth and improving social conditions:**

- *Moving toward external sustainability*, through regularization of arrears, HIPC and MDRI debt relief, higher external assistance, and domestic policy adjustments to improve external competitiveness.

- *Supporting private sector growth and economic diversification*, by developing the financial sector, improving the investment climate, simplifying the tax system, liberalizing trade, and enhancing competition and private sector involvement in infrastructure.

- *Enhancing the capacity of fiscal institutions*, by improving interisland cooperation, budget execution monitoring, expenditure management, and revenue administration.

Moving toward external sustainability

20. **A high priority for the authorities is bringing debt to a sustainable level through comprehensive debt relief.** A debt sustainability analysis (Appendix I), conducted jointly with World Bank staff, shows that debt would remain unsustainably high in the baseline scenario even without economic shocks. By contrast, in the adjustment scenario, based on an economic reform program and HIPC/MDRI debt relief, debt would come down to the point where it would be sustainable under a range of stress tests.

21. **The mission urged the authorities to build on recent momentum in arrears clearance discussions with official creditors** (see Section II.C for details). Reaching understandings with official creditors on clearing Comoros' large external arrears (25 percent of GDP) is a precondition for a PRGF arrangement, which in turn is required to make Comoros eligible for HIPC and MDRI debt relief. The specifics of arrears clearance and rescheduling will have implications for near-term debt service.

22. **The authorities called for more external assistance to support urgently needed institution-building and the reforms envisaged in the I-PRSP.** The 2005 donor conference generated about $200 million in external assistance pledges for 2006-09. Annualized, this would be triple the amount received in 2004-05, although it is only about half of what was envisaged in the I-PRSP. Additional assistance will likely be needed to clear arrears and achieve the MDGs. Authorities and staff agreed that new projects should be mostly grant-financed and that expenditure-tracking mechanisms need to be put in place to ensure that aid is used effectively.

23. **The mission discussed the causes of Comoros's apparent lack of external competitiveness, evidenced by poor export performance and growing external**

imbalances (Box 1). The authorities noted that structural constraints—in particular very high transport costs, the underdeveloped financial sector, and emigration—were the main reasons for low exports and the lack of sectoral diversification. They considered that the current level of private sector wages was not a major constraint on competitiveness, as exports are mainly produced from self-employment in agriculture.

Box 1: External Competitiveness and the Exchange Rate

The discussions highlighted linkages between export performance, external balances, the terms of trade, and the real exchange rate:

- *The size of the goods and services deficit (18 percent of GDP) is mostly explained by remittances and foreign aid.* About three-quarters of remittances and project aid are spent on imports, thus not directly affecting the real exchange rate. Such imports averaged an estimated 15 percent of GDP during 2001-05, which explains much of the goods and services deficit.

- *Exports are low mainly because of structural constraints and low vanilla prices.* Structural constraints include emigration, an underdeveloped financial sector, low institutional capacity, and high international transport costs.

- *Dollar wages are in line with comparable countries.* Wages and other local costs play a relatively minor role in agricultural production, which is family-based, though they are more important in tourism. At about €60–90 a month, private wages are not out of line with wages in other low-income countries. Government wages, which average €140 a month, are also not high by regional standards, but the public sector tends to siphon off skilled labor from the private sector.

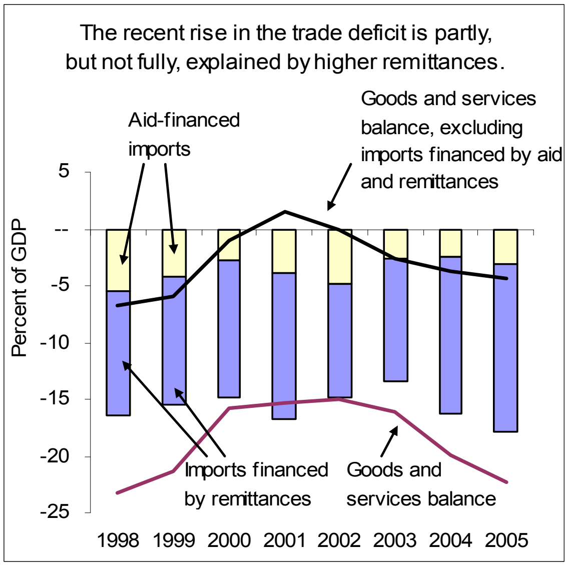
- *Past movements in the real exchange rate have had little discernible impact on exports.* The 33 percent devaluation in 1994 caused a lasting real exchange rate depreciation that averaged 17 percent against the ECU and 13 percent in real effective terms for the next five years but, in contrast to what happened in many other franc zone countries, exports did not pick up and the trade deficit increased. The episode highlighted the structural rigidities in Comoros, such as the limited capacity of the tradables sector and its high dependence on international export prices, which declined during 1995-98).

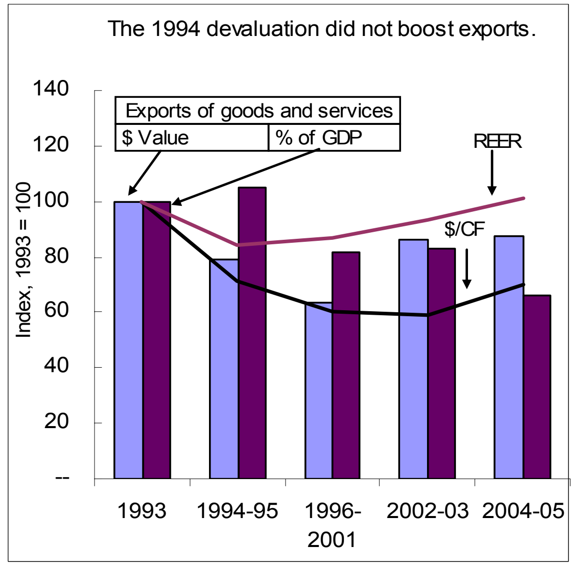
- *External imbalances have widened in recent years, reflecting real exchange rate appreciation and terms of trade shocks.* From 2002 to 2005, the goods and services balance deteriorated by more than 7 percentage points of GDP, partly reflecting rapid import growth caused by a surge in remittances. Excluding imports financed by remittances and foreign aid, the goods and services deficit deteriorated to an estimated 4½ percent of GDP in 2005, from near zero in 2002, mainly reflecting real exchange rate appreciation, rising oil prices, and the collapse in international vanilla prices.

Given poor data quality, especially for longer historical series, it is not possible to quantify the degree of potential exchange rate misalignment. On balance, the exchange rate seems to have become moderately overvalued, with recent terms of trade shocks and real exchange rate appreciation contributing to a growing but still moderate aid- and remittances-adjusted goods and services deficit.

24. **The large and growing goods and services deficit can be explained partly by the direct effect of remittances on imports and partly by relative price movements.** Because

remittances to Comoros are mainly spent on imports, they do not appear to have created a significant Dutch disease problem, notwithstanding short-term fluctuations in monetary aggregates and prices (Selected Issues, Chapter I). Strong import growth in recent years has been mainly driven by surging remittances. The current account deficit has widened moderately, reflecting rising oil prices, falling vanilla prices, and real exchange rate appreciation caused by the appreciation of the euro against other currencies.





25. **The authorities stressed that the hard exchange rate peg and safeguards under the franc zone arrangement have provided the country's main anchor of stability.** In their opinion, any short-term competitiveness gains from a devaluation would be limited by the narrow economic base, capacity constraints in agriculture and tourism, and possible negative feedback effects through increased emigration. Any potential benefits from an exchange rate realignment were likely to be outweighed by the adverse effects on domestic confidence in the currency, with a risk of further eurozation and higher lending rates. The authorities stressed that the fixed exchange rate regime, franc zone lending limits, and central bank independence had been critical for keeping inflation low. Staff agreed. Given the apparent moderate overvaluation of the currency (Box 1), staff emphasized the need to tighten fiscal policy and accelerate structural reforms aimed at promoting private sector development (see below), so as to enhance external competitiveness and prevent a continued widening of external imbalances.

Private sector development

26. **Policymakers and private sector representatives stressed that private sector growth will require a significant expansion of financial intermediation.** Lending rates are high and credit to the private sector, at 6 percent of GDP, is low even by regional standards and largely limited to short-term trade financing, partly reflecting credit risk, but also lack of

competition. The mission discussed medium-term reform priorities with the central bank, with a focus on preparing the supervisory framework for the prospective entry of several foreign banks and strengthening the supervision of microfinance institutions.

27. **There was consensus that higher FDI will be critical for raising GDP growth and improving external competitiveness.** In addition to capital, FDI would provide knowledge transfer and linkages to international markets. It could also enhance competition in the service industry and diversify the economy. The authorities stressed that their commitment to good governance would help improve the investment climate and noted their recent efforts to attract investors to the tourism and banking sectors. The mission pointed out that contract enforcement had been perceived as a problem by several foreign investors. The authorities noted their efforts to prepare a new investment code that would introduce a one-stop shop for investors and give them legal recourse to the courts.

28. **There was agreement on the need to further liberalize trade policy and simplify the tax system.** Important steps this year were the conversion of high specific import duties on key commodities into domestic excise taxes and the reduction in ad valorem tariff rates, with a new maximum rate of 30 percent. As a result, the average weighted import tariff declined to less than 20 percent in 2006. There was agreement that simplifying and further reducing import duties, eliminating exemptions, and overhauling the tax code would help improve the investment climate. One option under consideration is to introduce a low uniform ad valorem import tariff, a uniform domestic consumption tax, and excise taxes on a few commodities with high revenue potential. The mission advocated termination of the *forfait* regime (fixed charges on containers involving about a quarter of the value of all imports), which has depressed customs collection. The authorities thought the regime was useful in the short term to alleviate existing capacity constraints but agreed that it should be reviewed as part of a wider revenue reform. They reiterated their commitment to regional trade integration and implementing the COMESA free trade area.

29. **The mission emphasized the urgency of reforming public infrastructure companies, whose poor performance has impeded private sector growth.** It urged the authorities to accelerate their discussions with the World Bank/IFC on preparing a sector reform strategy for the telecommunications and hydrocarbons monopolies, including possible introduction of competition and privatization. Given the critical importance of these two companies for the fiscal revenue base, such reforms should accompany tax reform and improvement of revenue administration. The staff noted that greater competition would also be important in transportation, where high costs have impeded foreign trade and economic growth. The authorities agreed that these sectors need reform and that the precarious financial situation of Grande Comore’s electricity and water utility (Mamwe) affected the cash flow of its suppliers and reduced fiscal revenues. The government intends to become current on its utility bills and improve governance at Mamwe.

Improving fiscal institutions in a decentralized system

30. **Lack of interisland cooperation in the context of fiscal decentralization has undermined the country's institutional capacity** (see Selected Issues, Chapter II). Fiscal decentralization has been a cornerstone of the national reconciliation process but, as the authorities acknowledged, it has also created an excessively large civil service. Many functions are replicated at each level of government. Without effective interisland information-sharing and policy coordination, decentralization has also undermined transparency and administrative capacity. The mission stressed that the resulting weakness in fiscal institutions, including the lack of timely consolidated data, has contributed to chronic arrears, poor expenditure targeting, volatile revenues, and low levels of aid. The revenue-sharing mechanism, with a large share of each government's revenue designated for distribution, has created free-rider incentives that impair revenue collection. The collapse in revenues ahead of the presidential power transfer highlighted these problems.

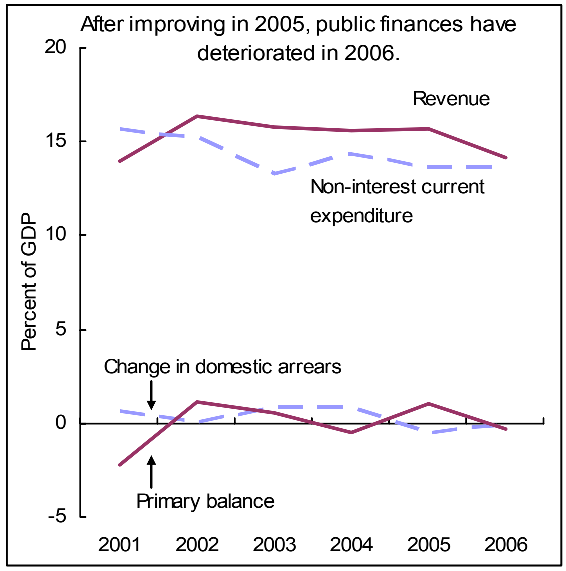
31. **The new government has centered its reform strategy on improved governance and transparency, with a near-term focus on strengthening fiscal institutions.** It has already moved to reinforce the management of revenue agencies and public enterprises. The mission stressed the importance of further improvements to fiscal transparency and intergovernmental coordination. It was agreed that customs procedures should be strengthened, including through external import valuation on all islands, following the recent suspension of operations by the existing pre-shipment agent on Grande Comore due to contractual disputes. There was also agreement that accounting of consolidated budget execution and large taxpayers administration should be unified this year, and that economic statistics need to be strengthened significantly for both Union and island-level data. Policymakers agreed that the civil service must be streamlined and downsized to make operations more effective, reduce the public wage bill, and create an opportunity to redeploy skilled labor to the private sector. As a short-term measure, they aim to reduce the wage bill through new budget ceilings for all ministries except education and health, to be followed by broader civil service reforms.

II. Program Discussions

A. Performance Under the SMP Through June 2006

32. **After improving in 2005, public finances deteriorated sharply in the run-up to the May 2006 presidential elections, and most SMP targets were missed by wide margins.** The primary surplus increased sharply in 2005 and domestic arrears were reduced for the first time in years, but several important quantitative and structural targets under the

2005 SMP were not met (Country Report No. 06/193). In the first half of 2006, revenues fell 17 percent short of the SMP target (10 percent below the same period last year), in large part due to governance problems in customs and public enterprises during the pre-election period. Moreover, some revenues were diverted away from treasury accounts and the interisland revenue-sharing mechanism was disrupted. Primary current spending exceeded the target by 1 percent of GDP, salary arrears and borrowing from the central bank increased drastically, and the domestic primary balance turned sharply negative.



33. **The new government moved quickly to investigate pre-election corruption and restore interisland cooperation, in line with President Sambi's emphasis on good governance.** Four inspection commissions have reviewed the management of revenue agencies and public enterprises, and several senior officials have been arrested. To restore interisland cooperation in fiscal matters, the four ministers of finance of the Union and island governments agreed in late June to meet monthly, ensure that all revenues are channeled through a single account, and enhance transparency and controls in revenue administration by placing Union officials in key positions at the island level.

B. Extension of the SMP Through December 2006

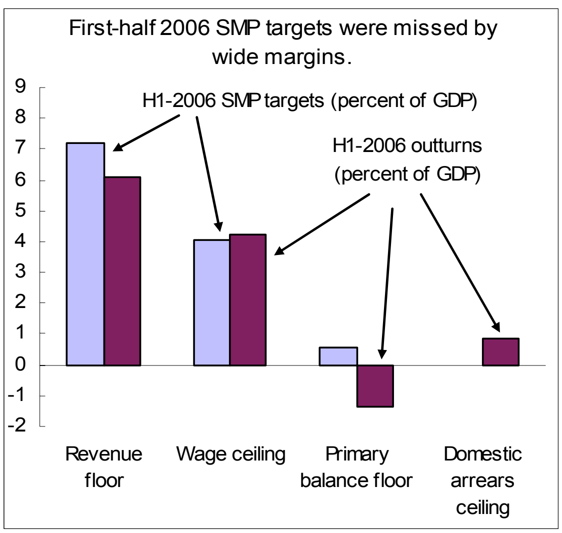
34. **The SMP was extended through December 2006 to bring fiscal performance into line with original program objectives for the second half of the year** (see Letter of Intent, Attachment I). The quantitative targets for the extended SMP were set with a view to restoring revenue collection and sharply reducing primary current expenditure compared to the original flow targets for the second half of the year, in order to make up for part of the deviations that occurred in the first half (Attachment I, Table 1). This would limit the full-year primary fiscal deficit to ¼ percent of GDP for the year as a whole and keep net domestic arrears and borrowing from the central bank close to zero. Specific objectives for the second half of 2006 are to:

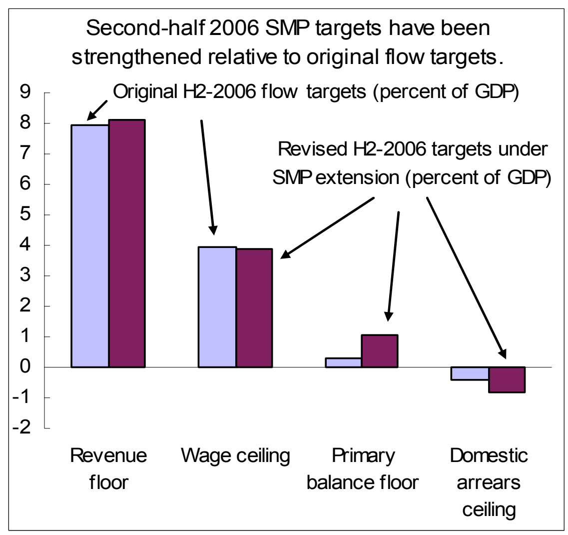
- *Restore fiscal revenue collection*, aiming for nominal revenues in line with the original flow target for the second half of 2006, despite lower GDP. Here the mission helped the authorities to identify near-term administrative measures to restore revenue collection at customs (see Attachment I).

- *Curtail expenditure.* Parliament approved a supplementary budget in August with spending cuts of just over ¾ percent of GDP for the second half of the year; these would effectively reverse the spending overrun in the first half.

- *Pay down wage arrears* accumulated in the first half of the year to keep net domestic arrears accumulation near zero for the year as a whole. This objective can only be met with substantial donor support. France has already provided €1.5 million in grants and the EU is considering additional support.

- *Accelerate structural reforms.* In addition to the comprehensive fiscal reforms carried out by the new government this summer (Attachment I), the SMP is aimed at implementing the structural reforms that were planned earlier but delayed by the elections. Among them are improving the monitoring of budget execution, reinforcing revenue administration for large taxpayers, preparing reforms for the telecommunication and hydrocarbons monopolies, and finalizing a draft new investment code.





35. **The 2007 budget is expected to target a domestic primary surplus of close to 1 percent of GDP.** This would allow for some clearance of domestic arrears and external debt service. Revenues should increase by about 1½ percentage points of GDP, although the specific revenue target will depend on tax and customs code reforms. The mission discussed with the authorities options for a further shift from trade-based to domestic taxation. The authorities requested technical assistance from the IMF to prepare such reforms. Meanwhile, the government intends to reduce the public wage bill and reallocate spending to social sectors and public investment, which will require a significant increase in external assistance.

C. PRGF Prospects

36. **The authorities stressed that entering a PRGF arrangement is a strategic priority for them.** They consider a PRGF arrangement to be critical for achieving the I-PRSP's key objectives by anchoring their medium-term economic reform program, ensuring sound public finances, unlocking donor support, and paving the way for comprehensive debt relief. The government expressed regret that fiscal mismanagement in the months before the May elections had delayed a PRGF arrangement and urged staff to conclude negotiations as soon as possible. The staff noted that, ahead of a PRGF arrangement, Comoros would need to establish a satisfactory track record relative to quantitative and structural SMP targets through end-December 2006, and reach understandings with official creditors on mechanisms to clear its large stock of external arrears.

37. **Much progress has been made on external arrears clearance discussions, but arrears to the AfDB remain a significant hurdle.** Comoros is $93 million in arrears to official creditors, equivalent to about 160 percent of revenues and 106 percent of reserves (Table 6). After an informal creditors meeting at the IMF in April 2006, the Arab Bank for Economic Development in Africa (BADEA) offered a long-term rescheduling of arrears, and the authorities have discussed similar mechanisms with the Kuwait and Saudi Funds. The Paris Club has indicated the possibility of a rescheduling of bilateral debt. Comoros is currently not eligible for the AfDB Group's post-conflict country facility and no financing mechanism for the $30 million in arrears to the Group has been identified.

D. Program Risks

38. **Program implementation is subject to substantial risks.** Political instability and interisland conflict remain key concerns. Because the new administration represents a major break with the old political order, new tensions could well emerge, including during the run-up to the island presidential elections in the spring of 2007. There is also a high risk that slow progress on enhancing institutional capacity and interisland cooperation could prevent the government from meeting its ambitious revenue and expenditure targets for the remainder of 2006, further delaying a prospective PRGF arrangement. Other potential risks are external shocks, such as a further worsening of the terms of trade or a decline in remittances, and natural disasters, such as a major volcanic eruption. Finally, poor data quality will continue to hamper economic analysis and policy formulation.

III. Staff Appraisal

39. **Comoros faces significant economic and political challenges.** The most urgent macroeconomic tasks are to remedy the recent deterioration in public finances and reach understandings on clearing external arrears, which could open the way for enhanced donor support and a PRGF arrangement. For the medium term, the authorities are rightly focused on raising economic growth and improving social conditions, in line with I-PRSP objectives. This will require continued political normalization and steps to address the country's lack of institutional capacity, its unsustainable debt position, and its narrow economic base.

40. **The fiscal priorities are to restore revenues and curtail spending so that domestic arrears can be reduced and the SMP brought back on track.** Following the severe slippages in SMP implementation in the first half of 2006, the new Union government acted quickly to restore interisland cooperation and strengthen governance in revenue agencies and public enterprises. It then took steps to bolster revenue administration and contain spending, with key measures approved by parliament in a supplementary budget. These measures should help Comoros return to a broadly balanced primary fiscal position for the year as a whole. To maintain stability, it will be important to respect the independence of the central bank and the franc zone borrowing ceiling.

41. **Clearing external arrears is a key hurdle on the path to debt sustainability.** Comoros has been running arrears to official creditors for two decades and does not have the capacity to service its external debt obligations. Understandings on clearing arrears clearance are required ahead of a PRGF arrangement, which in turn is a prerequisite for eventual HIPC and MDRI debt relief. In the near term, the authorities should make every effort to reach arrears clearance agreements while avoiding a significant increase in near-term debt service commitments. In this regard, the arrears rescheduling schemes recently offered by key creditors are welcome steps in this direction.

42. **Weak interisland coordination of economic policy, in the context of fiscal decentralization, has been at the core of governance problems in Comoros.** Decentralization is an important element of the national reconciliation process, but it requires greater efforts to avoid the pitfalls that have become apparent in recent years, such as an excessively large civil service, lack of transparency in government operations, inadequate incentives to collect revenue and curtail spending, and the absence of timely consolidated data. It is now critical to intensify interisland cooperation and unify certain government functions, including revenue administration of large taxpayers, monitoring of budget execution, and economic statistics. The authorities should also consider further improvements to the revenue-sharing mechanism to reinforce incentives for subnational revenue collection and expenditure management.

43. **Comoros will need substantial external assistance for the critical task of institution building, particularly technical assistance to enhance the capacity of fiscal**

institutions. Additional aid will be required to finance external arrears clearance and the social spending and public investment programs the I-PRSP identified as necessary to make progress toward the MDGs.

44. **While external competitiveness is constrained primarily by structural factors, the recent real exchange rate appreciation and terms of trade shocks have exacerbated the situation.** Although the Comorian franc appears moderately overvalued, the current account deficit is not excessively large and a devaluation is unlikely to boost exports significantly in the short term. The authorities are rightly committed to maintaining the exchange rate peg under the franc zone arrangement, which has been the country's main anchor of macroeconomic stability. Structural reforms to improve the investment climate, develop the financial sector, overhaul the tax system, further liberalize trade, and introduce competition and private sector involvement in infrastructure offer the most promising avenue for enhancing external competitiveness.

45. **Improvements to the investment climate will be critical for attracting FDI and raising the country's economic growth potential.** Large inflows of remittances have sustained consumption and provided a buffer against external shocks. To help redirect some of these resources toward growth-oriented investment and attract foreign investors, it will be important to improve the investment climate by improving governance and overhauling the tax, customs, and investment codes. Following recent reductions in import tariffs, a promising reform option under consideration is the introduction of a low uniform import tariff, a uniform domestic consumption tax, and excise taxes on a few commodities with high revenue potential. However, without structural reforms and external assistance to improve local transport and communication infrastructure, there is little prospect of significantly higher foreign investment.

46. **Financial sector development is needed to support private sector growth and economic diversification.** The prospective entry of foreign banks could help reduce the cost of credit and make services available beyond short-term trade financing. It would also present the central bank with new regulatory challenges, in addition to its efforts to strengthen supervision of microfinance institutions.

47. **After continued delays, it is increasingly urgent to introduce greater competition and private ownership in sectors currently dominated by inefficient public monopolies.** The authorities should accelerate their work with the IFC and World Bank on a reform strategy for the telecom and hydrocarbons companies, including possible privatization. Greater competition in transportation and financial rehabilitation of the energy and water utility are also urgently needed.

48. **There is considerable risk that economic performance and policy implementation will fall short of the authorities' objectives.** Institutional capacity problems and lack of interisland cooperation have been key reasons behind SMP slippages in

2005 and the sharp deterioration in public finances in early 2006. Unless remedied, these problems could prevent the rebound in fiscal revenues and cut in expenditures needed to bring the SMP back on track. Political tensions could reemerge if the new government is not able to solidify national reconciliation and improve living standards. Severe capacity in economic statistics will remain a significant obstacle to sound policy formulation for the foreseeable future.

49. **If implemented successfully, the authorities' policies could be the basis for a PRGF arrangement.** The new government has made a positive start in restoring interisland cooperation, improving governance, and restoring prudent fiscal management after the severe pre-election slippages earlier this year. The extended SMP focuses on restoring a balanced fiscal position and reforming fiscal institutions. Successful implementation would help establish a track record for entering into a PRGF arrangement, possibly in early 2007, in support of the authorities' medium-term economic reform program aimed at higher economic growth and poverty reduction.

50. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. Comoros: Selected Economic and Financial Indicators, 2002-07

	2002	2003	2004	2005	2006 1/		2007
					Prog.	Rev. Prog.	Proj.
National income and prices	(Annual percentage change unless otherwise indicated)						
Real GDP	4.1	2.5	-0.2	4.2	2.5	1.2	3.0
Real GDP per capita	2.0	0.3	-2.3	2.1	-0.2	-0.8	0.9
Nominal GDP (in millions of CF)	131,293	141,437	143,596	153,112	160,783	158,114	167,743
Nominal GDP (in millions of US$)	251.9	323.2	362.9	368.9	392.7	386.2	409.7
Nominal GDP per capita (in US$)	447.0	561.4	617.4	614.8	633.3	630.3	655.0
GDP deflator	4.2	5.1	1.8	2.3	2.0	2.0	3.0
Consumer price index (annual averages)	3.5	3.8	4.5	3.6	4.2	3.8	3.0
Money and credit							
Net foreign assets	6.0	-4.8	-1.6	0.9	3.2	-0.6	...
Domestic credit	12.3	-3.4	-3.6	9.0	2.1	-4.6	...
Broad money	9.1	-1.1	-6.3	3.1	3.3	-1.1	...
Velocity (GDP/average broad money)	4.1	4.5	4.8	5.0	5.1	5.2	...
Investment and savings	(in percent of GDP unless otherwise indicated)						
Investment	11.0	10.3	9.4	9.3	13.1	10.2	13.5
Public	5.8	5.4	4.4	4.5	7.0	5.3	6.6
Private	5.2	4.9	5.0	4.8	6.1	4.9	6.9
Gross national savings	9.6	7.2	6.5	6.0	9.3	5.6	7.6
Public	2.1	1.9	2.7	4.6	5.3	3.8	6.2
Private	7.5	5.3	3.8	1.4	4.0	1.9	1.4
Government budget							
Domestic revenue	16.4	15.8	15.6	15.7	15.2	14.2	15.7
Total grants	4.1	2.2	2.8	4.3	4.8	6.4	8.0
Total expenditure	24.1	21.5	20.1	19.9	21.7	22.1	24.1
Current expenditure	18.4	16.1	15.7	15.4	14.7	16.8	17.5
Change in arrears							
External interest	0.7	0.7	0.5	0.4	0.0	0.4	...
Domestic	0.1	0.9	0.8	-0.5	-0.4	0.0	-0.4
Domestic primary balance	1.1	0.5	-0.5	1.1	0.9	-0.3	1.0
Overall balance							
Commitment basis, including grants	-3.6	-3.4	-1.7	0.1	-1.7	-1.5	-0.4
Cash basis, including grants	-2.9	-1.9	-0.3	-0.5	-2.2	-1.1	-0.9
External sector							
Exports of goods and services	15.7	15.8	12.7	12.5	13.8	10.5	11.1
Imports of goods and services	30.8	31.8	32.6	34.7	29.2	37.3	38.4
Current account balance	-1.4	-3.1	-2.8	-3.3	-3.8	-4.5	-6.0
Excl. official and private transfers	-15.3	-16.5	-20.5	-22.9	-15.9	-27.4	-27.7
External debt (end of year)							
In percent of GDP	84.2	81.1	80.5	71.5	68.2	70.5	58.6
Of which: arrears	23.9	23.4	24.1	24.9	23.7	25.3	...
NPV, percent of exports of goods & services	...	...	...	419	...	493	...
External debt service							
In percent of exports of goods & services	14.7	14.0	17.6	16.8	13.4	18.6	20.8
In percent of government revenue	14.1	14.0	14.3	13.3	12.2	13.7	14.8
Official grants and loans	9.5	5.2	3.8	5.0	6.7	7.9	9.0
Gross international reserves (end of period)							
In millions of U.S. dollars	80.9	97.2	92.7	87.1	90.1	87.4	79.8
In months of imports of goods & services	12.5	11.3	9.4	8.2	9.4	7.3	6.1
Real effective exchange rate (2000=100)	113.8	116.8	123.6	126.0	...	...	...
Terms of trade (percent change)	0.8	75.6	-34.2	-43.9	6.6	-6.0	...
Exchange rate CF/US$ (period average)	521.1	437.6	395.7	415.0	...	...	...

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

1/ Program reflects SMP for Jan.-Jun. 2006 (Country Report No. 06/193). Revised program reflects SMP extension through December 2006.

Table 2. Comoros: Medium-term Scenarios: Baseline and Adjustment, 2005-10

	2005	2006	2007	2008	2009	2010
Baseline scenario 1/						
Real sector			(In units indicated)			
Real GDP (percent change)	4.2	1.2	2.0	2.0	2.0	2.0
GDP deflator (percent change)	2.3	2.0	2.5	2.5	2.5	2.5
Nominal GDP (US$ millions)	368.9	386.2	403.8	422.1	441.4	461.4
Investment (percent of GDP)	9.3	10.2	11.0	10.5	10.5	10.5
General government			(In percent of GDP)			
Grants	3.8	5.1	5.0	5.0	5.0	5.0
Domestic revenues	15.7	14.2	14.1	14.0	13.9	13.8
Domestic primary spending	14.6	14.5	14.7	14.8	14.9	15.0
Project spending and technical assistance	4.5	6.6	5.0	5.0	5.0	5.0
Domestic primary surplus	1.1	-0.3	-0.6	-0.8	-1.0	-1.2
Overall balance	0.1	-1.5	-1.2	-1.3	-1.5	-1.7
Change in arrears	-0.5	0.0	1.4	1.7	1.9	2.1
External sector			(In percent of GDP)			
Current account balance (incl. grants)	-3.3	-4.5	-4.5	-4.7	-4.9	-5.1
Exports of goods and services	12.5	10.5	10.7	10.7	10.7	10.7
Imports of goods and services	34.7	37.3	37.3	37.3	37.3	37.3
Current transfers	19.5	22.9	22.7	22.5	22.3	22.0
External debt	71.5	71.0	67.7	64.4	61.2	58.1
Of which: external arrears	24.9	25.3	25.5	25.5	25.5	25.5
External debt service due	2.1	1.9	2.1	2.0	2.0	1.9
NPV of ext. debt to exports of goods & services	419.4	493.2	470.9	457.1	444.5	430.9
Gross international reserves (months of imports)	8.2	7.3	6.5	5.4	4.3	3.1
Adjustment scenario 2/						
Real sector			(In units indicated)			
Real GDP (percent change)	4.2	1.2	3.0	4.5	4.5	4.5
GDP deflator (percent change)	2.3	2.0	3.0	3.0	3.0	3.0
Nominal GDP (US$ millions)	368.9	386.2	409.7	441.0	474.7	510.9
Investment (percent of GDP)	9.3	10.2	13.5	15.1	16.1	16.6
General government			(In percent of GDP)			
Grants	3.8	5.1	8.0	9.3	10.0	10.0
Domestic revenues	15.7	14.2	15.7	16.0	16.3	16.6
Domestic primary spending	14.6	14.5	14.6	15.0	15.4	15.8
Project spending and technical assistance	4.5	6.6	9.0	9.7	10.4	10.4
Domestic primary surplus	1.1	-0.3	1.0	0.9	0.8	0.7
Overall balance	0.1	-1.5	-0.4	0.1	0.1	0.1
Change in arrears	-0.5	0.0	-24.3	-0.4	-0.4	-0.5
External sector			(In percent of GDP)			
Current account balance (incl. grants)	-3.3	-4.5	-6.0	-5.9	-5.7	-5.4
Exports of goods and services	12.5	10.5	11.1	11.7	12.3	13.0
Imports of goods and services	34.7	37.3	38.4	38.4	38.2	38.0
Current transfers	19.5	22.9	21.8	21.1	20.4	19.5
External debt	71.5	70.5	58.6	52.6	16.4	15.5
Of which: external arrears	24.9	25.3	0.0	0.0	0.0	0.0
External debt service due	2.1	1.9	2.3	1.7	1.6	0.7
NPV of ext. debt to exports of goods & services	419.4	493.2	310.9	271.8	74.0	64.5
Gross international reserves (months of imports)	8.2	7.3	6.1	6.1	6.3	6.4

Sources: Comorian authorities and Fund staff estimates and projections.

1/ Based on unchanged policies.

2/ Reflects economic reform program, external assistance in line with December 2005 donors conference, and debt relief under HIPC/MDRI in 2009. External arrears are assumed to be rescheduled in 2007.

Table 3. Comoros: Balance of Payments, 2003-10

	2003	2004	2005	2006	2007	2008	2009	2010
			Prel.	Proj.	Adjustment scenario			
	(in millions of U.S. dollars, unless otherwise indicated)							
Current account	-10.1	-10.3	-12.3	-17.4	-24.5	-26.0	-26.8	-27.5
Goods and services	-52.0	-72.3	-82.1	-103.5	-111.8	-117.6	-122.7	-127.4
Trade balance	-39.9	-62.0	-76.8	-92.2	-97.9	-103.2	-108.6	-114.5
Exports (f.o.b.)	26.7	18.7	13.8	10.6	12.9	14.8	17.1	19.7
Of which: vanilla	20.9	8.6	3.2	2.2	2.4	2.7	2.9	3.2
cloves	3.6	7.3	7.4	5.0	6.5	7.5	8.6	9.9
ylang-ylang	1.5	2.1	2.4	2.6	3.0	3.5	4.0	4.6
Imports (f.o.b.)	-66.7	-80.7	-90.6	-102.9	-110.8	-118.0	-125.7	-134.2
Of which: petroleum products	-13.6	-17.9	-20.2	-23.7	-26.3	-29.0	-31.9	-35.1
Services (net)	-12.0	-10.2	-5.3	-11.3	-14	-14	-14	-13
Receipts	24.2	27.3	32.2	30.0	32.8	36.8	41.4	46.7
Of which: travel	10.7	12.5	14.1	11.6	13.3	15.7	18.6	21.9
Payments	-36.2	-37.5	-37.5	-41.2	-46.7	-51.2	-55.5	-59.7
Income (net)	-1.3	-2.2	-2.3	-2.5	-1.8	-1.5	-1.1	0.4
Current transfers (net)	43.2	64.1	72.1	88.5	89.1	93.1	97.0	99.6
Government	1.9	4.7	7.1	14.5	13.8	16.4	19.0	20.4
Private	41.3	59.4	65.0	74.0	75.4	76.7	78.0	79.2
Capital and financial account	14.4	7.0	3.5	11.6	18.1	23.9	20.9	32.5
Capital transfers	5.2	5.4	8.7	10.3	19.0	24.6	176.1	30.7
Financial account	9.2	1.6	-5.2	1.3	-0.9	-0.7	-155.2	1.8
Direct investment	1.4	1.8	1.9	2.0	2.9	3.2	3.5	3.9
Net portfolio and other investment	7.8	-0.1	-7.1	-0.7	-3.8	-4.0	-158.7	-2.1
Government	5.7	-1.2	-2.6	0.5	-3.7	-4.0	-158.2	-1.0
Drawings	9.5	3.7	2.5	5.6	4.0	1.9	2.0	2.1
Amortization	-3.7	-4.9	-5.2	-5.1	-7.7	-5.9	-6.0	-3.0
MDRI & HIPC	--	--	--	--	--	--	-154.1	--
Banks, net	2.2	0.8	-4.9	-0.9	-0.5	-0.7	-0.7	-0.8
Other	-0.2	0.3	0.5	-0.3	0.4	0.7	0.1	-0.3
Errors and omissions	-10.7	-1.0	1.2	--	--	--	--	--
Overall balance	-6.3	-4.3	-7.6	-5.9	-6.4	-2.1	-5.9	5.0
Financing	6.3	4.3	7.6	5.9	6.4	2.1	5.9	-5.0
NFA of central bank (- increase)	2.2	0.7	4.1	1.4	6.9	-6.1	-8.9	-8.8
Net change in arrears	4.2	3.5	3.5	4.5	-97.8	--	--	--
Exceptional financing	--	--	--	--	87.4	--	6.5	--
Financing gap 1/	--	--	--	--	9.9	8.2	8.3	3.8
Memorandum items:								
Current account (percent of GDP)	-3.1	-2.8	-3.3	-4.5	-6.0	-5.9	-5.7	-5.4
Excluding transfers	-16.5	-20.5	-22.9	-27.4	-27.7	-27.0	-26.1	-24.9
Exports of goods & services (percent of GDP)	15.8	12.7	12.5	10.5	11.1	11.7	12.3	13.0
Imports of goods & services (percent of GDP)	31.8	32.6	34.7	37.3	38.4	38.4	38.2	38.0
External public debt								
In millions of U.S. dollars	295	285	266	275	240	232	78	79
Of which: arrears	85	85	93	99	--	--	--	--
In percent of GDP	81.1	80.5	71.5	70.5	58.6	52.6	16.4	15.5
Debt service (% of exports of goods & services	14.0	17.6	16.8	18.6	20.8	14.4	12.8	5.3
Exchange rate CF/US$ (period average)	438	396	415	409	…	…	…	…
Gross international reserves								
In millions of U.S. dollar	97	93	87	87	80	86	95	104
In months of imports of goods and services	11.3	9.4	8.2	7.3	6.1	6.1	6.3	6.4
Nominal GDP (millions U.S. dollar)	323.2	362.9	368.9	386.2	409.7	441.0	474.7	510.9

Sources: Comorian authorities, and Fund staff estimates and projections.

1/ Financing gaps for 2007-09 are projected to be covered in part by interim debt relief after HIPC Decision Point.

Table 4. Comoros: Monetary Survey, 2004-06

	2004 Dec.	2005 Dec.	2006 March Prel.	2006 June Prel.	2006 Sept Prog.	2006 Dec Prog.
	(In millions of Comorian francs)					
Monetary survey						
Net foreign assets	37,057	37,398	37,145	35,027	35,354	37,191
Net domestic assets	-7,326	-6,748	-8,081	-4,419	-4,900	-6,891
Domestic credit	12,641	13,780	13,443	14,615	13,680	13,145
Net credit to government	2,170	3,450	3,919	5,131	4,352	3,864
Claims on public enterprises	167	44	158	153	153	153
Claims on other financial institutions	68	60	61	69	60	60
Claims on private sector	10,236	10,227	9,305	9,262	9,216	9,169
Other items net	-19,967	-20,528	-21,524	-19,033	-18,580	-20,036
Broad money	29,730	30,649	29,064	30,609	30,454	30,300
Money	20,894	22,802	21,128	22,794	22,839	23,369
Currency in circulation	11,730	11,456	10,664	11,231	11,336	11,925
Demand deposits	9,164	11,346	10,464	11,562	11,503	11,445
Quasi-money	8,836	7,847	7,936	7,815	7,615	6,931
Central bank						
Net foreign assets	37,420	35,718	34,258	34,515	34,794	35,146
Net domestic assets	-9,926	-8,966	-7,763	-6,933	-7,196	-7,041
Domestic credit	2,286	3,781	4,224	5,586	4,706	4,218
Net credit to government	2,188	3,677	4,128	5,485	4,605	4,117
Claims on government	3,457	4,538	4,428	6,129	5,249	4,761
Deposits of government	-1,270	-860	-299	-644	-644	-644
Other items net	-12,212	-12,747	-11,987	-12,520	-11,902	-11,259
Reserve money	27,494	26,751	26,495	27,582	27,598	28,104
Currency in circulation	11,730	11,456	10,664	11,231	11,336	11,925
Bank reserves	13,841	12,973	13,966	15,063	14,987	14,911
Private sector deposits						
Cash holdings	120	98	144	192	191	190
Deposits	13,721	12,875	13,822	14,871	14,796	14,721
Deposits of other financial institutions	1,762	1,470	1,478	1,021	1,010	1,005
Deposits of public enterprises	160	853	388	268	265	264
Deposit money banks						
Net foreign assets	-363	1,680	2,887	512	560	2,045
Net Domestic Assets	18,203	16,660	15,125	18,598	18,293	16,066
Domestic credit	10,355	9,999	9,219	9,029	8,974	8,927
Net credit to government	-18	-228	-209	-354	-354	-354
Claims on public enterprises	167	44	158	153	153	153
Claims on other financial institutions	18	10	11	19	10	10
Claims on private sector	10,187	10,173	9,259	9,211	9,164	9,118
Claims on other financial institutions	18	10	11	19	10	10
Bank reserves	14,919	13,324	12,936	14,690	14,617	14,544
Other items net	-7,071	-6,663	-7,029	-5,121	-5,298	-7,405
Total deposits	17,840	18,341	18,012	19,110	18,853	18,112
Demand deposits	9,004	10,493	10,076	11,295	11,238	11,181
Term and savings deposits	8,836	7,847	7,936	7,815	7,615	6,931
Memorandum items:	(change in percent of end-year broad money, unless otherwise indicated)					
Net foreign assets	-1.9	1.1	-0.8	-7.7	-6.7	-0.7
Domestic credit	-1.5	3.8	-1.1	2.7	-0.3	-2.1
Broad money	-6.3	3.1	-5.2	-0.1	-0.6	-1.1
Velocity (GDP/average M2)	4.8	5.0	5.4	5.2	5.2	5.2
Credit to private sector (percent change)	-10.0	-0.1	-9.0	-9.4	-9.9	-10.3

Sources: Central Bank of Comoros; and Fund staff estimates and projections.

Table 5. Comoros: Consolidated Government Financial Operations, 2004-07
(in millions of Comorian francs, unless otherwise indicated)

	2004	2005	2006								2007
			Jan-Mar.		Jan-June		Jan-Sept.		Jan-Dec.		
	Actual	Actual	Prog. 1/	Actual	Prog. 1/	Prelim.	Prog. 1/	Rev. 2/	Prog. 1/	Rev. 2/	Proj.
Total revenue and grants	26,434	30,509	5,825	6,887	14,178	14,471	23,370	22,818	32,114	32,609	39,671
Revenues	22,445	23,972	4,650	4,479	11,600	9,656	18,075	16,131	24,400	22,456	26,252
Tax revenues	19,407	17,797	3,592	3,944	8,700	7,808	14,470	13,578	19,850	18,958	22,163
Nontax revenues	3,038	6,175	1,058	535	2,900	1,848	3,605	2,553	4,550	3,498	4,089
External grants	3,989	6,537	1,175	2,407	2,578	4,815	5,295	6,687	7,714	10,153	13,419
Budgetary assistance	153	669	0	0	0	0	0	750	0	2,014	0
Projects (incl. techn.assist.)	3,836	5,868	1,175	2,407	2,578	4,815	5,295	5,937	7,714	8,139	13,419
Total expenditure and net lending	28,847	30,425	6,550	8,898	15,497	19,144	24,434	26,051	34,888	34,970	40,419
Current expenditure	22,546	23,523	4,844	6,135	11,061	13,834	16,364	19,761	23,644	26,621	29,298
Primary current expenditures	20,658	20,911	4,482	4,871	10,084	11,207	14,849	15,972	21,399	21,576	22,803
Wages and salaries	12,631	12,872	3,300	3,247	6,500	6,719	9,650	9,869	12,799	12,900	12,748
Goods and services	6,038	5,160	925	1,287	2,736	2,959	3,864	4,087	5,741	5,648	6,591
Transfers	1,989	2,879	257	338	848	1,529	1,336	2,017	2,859	3,029	3,463
Interest payments	1,282	1,182	212	244	527	587	715	804	1,045	1,115	859
External debt	1,187	1,048	190	200	480	499	668	697	950	989	741
Domestic debt	95	134	22	44	47	88	47	107	95	126	118
Foreign-financed project assistance	...	784	...	394	...	788	...	1,360	...	1,932	2,340
Technical assistance	606	647	150	626	450	1,252	800	1,625	1,200	1,998	3,296
Capital expenditure	6,301	6,902	1,706	2,763	4,436	5,311	8,070	6,290	11,244	8,349	11,121
Domestically financed investment	2,539	1,411	63	225	580	636	950	1,032	1,628	1,428	1,700
Foreign-financed investment	3,762	5,491	1,643	2,137	3,856	4,274	7,120	4,857	9,616	6,520	9,421
Counterpart funds-financed	...	...	...	401	...	401	...	401	...	401	...
Domestic primary balance	-752	1,650	105	-617	936	-2,188	2,276	-873	1,373	-548	1,749
Overall balance (commitment basis)	-2,413	83	-725	-2,011	-1,318	-4,674	-1,064	-3,233	-2,774	-2,361	-747
Excluding budget support	-2,566	-586 0	-725	-2,011	-1,318	-4,674	-1,064	-3,983	-2,774	-4,375	-747
Change in net arrears	1,862	-272	0	1,153	0	1,657	-300	1,318	-700	613	-700
Interest on external debt	665	542	0	94	0	308	0	407	0	613	0
Domestic arrears	1,197	-814	0	1,060	0	1,348	-300	911	-700	0	-700
Change in Treasury accounts	125	-548	0	-69	0	-128	0	-64	0	0	0
Overall balance (cash basis)	-426	-737	-725	-926	-1,318	-3,145	-1,364	-1,979	-3,474	-1,748	-1,447
Financing	829	1,117	724	944	1,319	2,724	1,364	1,979	2,225	1,748	-1,035
Foreign (net)	262	-163	104	475	717	1,043	1,101	1,178	1,069	1,435	-1,510
Drawings, PIP (identified)	1,462	1,054	618	749	1,728	1,499	2,625	1,905	3,102	2,311	1,638
Amortization	-1,935	-2,152	-514	-529	-1,011	-1,041	-1,524	-1,570	-2,033	-2,093	-3,147
Arrears (principal)	735	935	0	254	0	585	0	843	0	1,217	0
Domestic (bank financing, net)	567	1,279	620	470	602	1,682	263	802	-44	314	475
Privatization revenues	...	...	...	...	...	...	...	...	1,200	0	0
Errors and omissions	-403	-380	...	-18	...	421	...	...	...	...	...
Financing gap	...	...	...	...	...	...	...	0	1,249	0	2,482
Memorandum items:					(in percent of GDP)						
Grants	2.8	4.3	0.7	1.5	1.6	3.0	3.3	4.2	4.8	6.4	8.0
Domestic revenue	15.6	15.7	2.9	2.8	7.2	6.1	11.2	10.2	15.2	14.2	15.7
Expenditure	20.1	19.9	4.1	5.6	9.6	12.1	15.2	16.5	21.7	22.1	24.1
Non-interest domestic expenditure	15.2	14.6	2.8	3.2	6.6	7.5	9.8	10.8	14.3	14.5	14.6
Wages and salaries	8.8	8.4	2.1	2.1	4.0	4.2	6.0	6.2	8.0	8.2	7.6
Social expenditure	...	8.1	2.1	...	4.4	...	6.9	7.0	9.5	9.7	11.7
Domestic primary balance	-0.5	1.1	0.1	-0.4	0.6	-1.4	1.4	-0.6	0.9	-0.3	1.0
Overall balance (commitment basis)	-1.7	0.1	-0.5	-1.3	-0.8	-3.0	-0.7	-2.0	-1.7	-1.5	-0.4
excluding budgetary support	-1.8	-0.4	-0.5	-1.3	-0.8	-3.0	-0.7	-2.5	-1.7	-2.8	-0.4
Overall balance (cash basis)	-0.3	-0.5	-0.5	-0.6	-0.8	-2.0	-0.8	-1.3	-2.2	-1.1	-0.9
Nominal GDP (in millions of CF)	143,596	153,112	160,783	158,114	160,783	158,114	160,783	158,114	160,783	158,114	167,743

Sources: Ministry of Finance; and Fund staff estimates.

1/ Based on January-June 2006 SMP, see Country Report 06/193.

2/ Based on SMP extension through end-December 2006. Revisions reflect end-June 2006 preliminary outturn.

Table 6. Comoros: External Debt and Arrears, Official Creditors, 2005-06

Creditors	2005 Stocks: Total debt	2005 Stocks: *Of which:* Arrears	2005 Flows: Debt service due	2005 Flows: Change in arrears	2006 Flows: Debt service due
	(in millions of U.S. dollars)				
Total	265.6	92.7	7.7	3.4	7.5
Multilaterals	219.4	61.9	6.6	2.3	6.6
AfDB Group	62.6	28.7	1.4	1.0	1.7
BADEA	26.2	26.2	0.4	0.4	0.4
EIB	0.6	0.1	0.2	0.2	0.0
IDB-OPEC	13.0	6.8	1.3	0.7	1.4
IFAD	8.2	0.1	0.3	...	0.3
IDA	109.3	0.0	3.0	0.0	2.8
Bilaterals	46.2	30.8	1.1	1.1	0.9
UAE (Abu Dhabi)	1.2	1.2	0.0	0.0	0.0
France (AFD)	4.5	0.0	...	...	...
China	1.24	1.2	...	...	...
Kuwait Fund	24.9	15.0	1.0	1.0	0.8
Saudi Fund	13.4	13.4	0.1	0.1	0.1
Mauritius	1.0	0.0	0.0	0.0	0.0

Source: Comorian authorities. Data not reconciled with creditor statements.

Table 7: Comoros: Millennium Development Goals

	1990	1995	2001	2002	2015 Target
Goal 1. Eradicate extreme poverty and hunger					
Target 1: Halve between 1990 and 2015, the proportion of people whose income is less than one dollar a day.					
1. Population below US$1 a day (percent)	...	...	...	...	...
2. Poverty gap ratio at US$1 a day (percent)	...	...	...	...	...
3. Share of income or consumption held by poorest 20 percent (percent)	...	...	...	...	...
Target 2: Halve, between 1990 and 2015, the proportion of people suffering hunger					
4. Prevalence of child malnutrition (percent of children under 5)	18.5	25.8	25.4	26	9.3
5. Population below minimum level of dietary energy consumption (percent)	...	...	...	...	...
Goal 2. Achieve universal primary education					
Target 3: Ensure that, by 2015, children will be able to complete a full course of primary schooling					
6. Net primary enrollment ratio (percent of relevant age group)	...	52.0	54.7	...	100.0
7. Percentage of cohort reaching grade 5	45.5	...	…	...	100.0
8. Youth literacy rate (percent age 15-24)	56.7	57.7	58.8	59.0	...
Goal 3. Promote gender equality and empower women					
Target 4: Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education by 2015					
9. Ratio of girls to boys in primary and secondary education (percent)	71.0	81.3	82.4	…	100.0
10. Ratio of young literate females to males (percent ages 15-24)	77.8	78.5	79.4	79.5	100.0
11. Share of women employed in the nonagricultural sector (percent)	...	...	...	...	...
12. Proportion of seats held by women in the national parliament (percent)	...	...	...	...	...
Goal 4. Reduce child mortality					
Target 5: Reduce by two-thirds between 1990 and 2015, the under-five mortality rate					
13. Under-five mortality rate (per 1,000)	120.0	100.0	82.0	79.0	40.0
14. Infant mortality rate (per 1,000 live births)	88.0	74.0	61.0	59.0	...
15. Immunization against measles (percent of children under 12-months)	87.0	69.0	70.0	71.0	...
Goal 5. Improve maternal health					
Target 6: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.					
16. Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	…	480.0	...	...
17. Proportion of births attended by skilled health personnel	...	51.6	61.8	...	...
Goal 6. Combat HIV/AIDS, malaria and other diseases					
Target 7: Halt by 2015, and begin to reverse, the spread of HIV/AIDS					
18. HIV prevalence among females (percent ages 15-24)	...	...	...	...	...
19. Contraceptive prevalence rate (percent of women ages 15-49)	...	21.0	...	...	...
20. Number of children orphaned by HIV/AIDS	...	...	...	...	...
Target 8: Halt by 2015, and begin to reverse, the incidence of malaria and other major diseases					
21. Prevalence of death associated with malaria	...	...	...	...	...
22. Share of population in malaria risk areas using effective prevention and treatment	...	...	...	...	...
23. Incidence of tuberculosis (per 100,000 people)	...	...	61.0	60.7	...
24. Tuberculosis cases detected under DOTS (percent)	...	60.0	43.0	...	...

Table 7: Comoros: Millennium Development Goals (continued)

	1990	1995	2001	2002	2015 Target
Goal 7. Ensure environmental sustainability					
Target 9: Integrate the principles of sustainable development into policies and programs. Reverse the loss of environmental resources					
25. Forest area (percent of total land area)	5.4	...	3.6	...	...
26. Nationally protected areas (percent of total land area)	...	0.0	0.0		
27. GDP per unit of energy use (PPP $ per kg oil equivalent)	...	...	...	...	...
28. CO2 emissions (metric tons per capita)	0.2	0.1	0.1	...	...
29. Proportion of population using solid fuels	...	...	...	...	...
Target 10: Halve by 2015 proportion of people without access to safe drinking water					
30. Access to improved water source (percent of population)	88.0	...	96.0	...	...
Target 11: Achieve by 2020 significant improvement for at least 100 million slum dwellers					
31. Access to improved sanitation (percent of population)	98.0	...	98.0	...	...
32. Access to secure tenure (percent of population)	...	...	...	...	...
Goal 8. Develop a Global Partnership for Development 1/					
Target 16: Develop and implement strategies for productive work for youth.					
45. Unemployment rate of population ages 15-24 (total)	...	...	...	...	...
Female	...	...	...	...	...
Male	...	...	...	...	...
Target 17: Provide access to affordable essential drugs					
46. Proportion of population with access to affordable essential drugs	...	...	...	...	...
Target 18: Make available new technologies, especially information and communications					
47. Fixed line and mobile telephones (per 1,000 people)	7.5	7.2	12.2	13.5	...
48. Personal computers (per 1,000 people)	0.1	0.3	5.5	5.5	...

Sources: World Bank; and Fund staff estimates.

1/ Targets 12-15 and indicators 33-44 are excluded because they cannot be measured on a country-specific basis. These are related to official development assistance, market access, and the HIPC initiative.

Union of the Comoros: Debt Sustainability Analysis

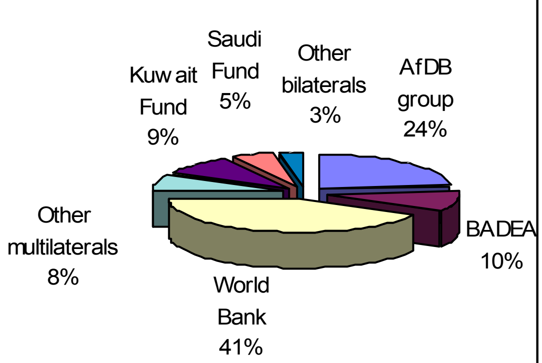
1. This assessment of Comoros's external public debt dynamics was prepared jointly with Bank staff based on the IMF-World Bank debt sustainability analysis (DSA) for low-income countries. It makes clear that in a baseline scenario of unchanged policies, Comoros would remain in debt distress even in the absence of shocks. In an adjustment scenario, which assumes improved economic performance and HIPC/MDRI debt relief at end-2009, debt would become sustainable even under a variety of stress tests. Comoros's external arrears are a major near-term hurdle for achieving debt sustainability, and the specifics of arrears clearance mechanisms will have important implications for near-term debt service.

I. Background

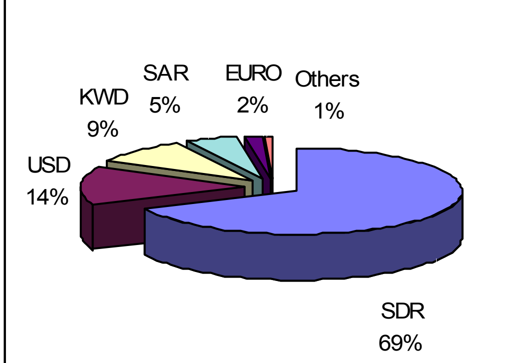
2. **External debt has been unsustainable for over two decades.** Large-scale borrowing from official creditors after independence led to rapid accumulation of external debt, which had reached 100 percent of GDP by the mid-1980s. The debt burden became quickly unsustainable and arrears as a proportion of total debt increased from 9 percent in 1984 to 35 percent in 2005. At yearend 2005, the net present value (NPV) of total debt amounted to 419 percent of exports of goods and services. Though debt service to the World Bank has been paid in full, arrears to most other official creditors have accumulated.

3. **At end-2005, Comoros's public external debt was estimated to be $266 million (72 percent of GDP).** Multilateral creditors accounted for 82 percent of this and the two largest creditors were the World Bank and the AfDB Group. Comoros has no loans from the IMF. With 69 percent of its total debt stock in SDRs, 14 percent in U.S. dollars, and 14 percent in currencies that are linked to the U.S. dollar, Comoros's external position is highly exposed to fluctuations of the euro (to which the Comorian franc is pegged) against the U.S. dollar. Since 2001, Comoros has benefited from the depreciation of the U.S. dollar against the euro, which has contributed to a gradual reduction in its debt-to-GDP ratio.

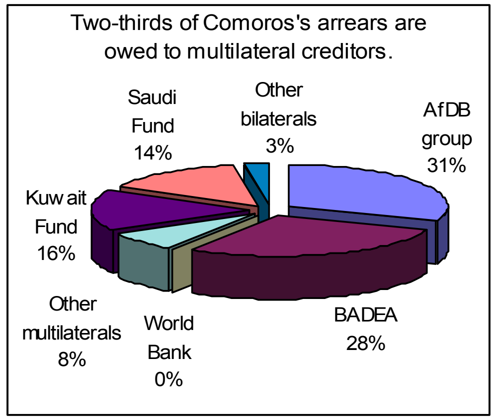
More than 80 percent of Comoros's debt is owed to multilateral creditors.



Most of the debt stock is affected by the Euro/U.S. dollar rate.



4. **Comoros has accumulated a large stock of arrears.** Arrears to official creditors amounted to $93 million at the end of 2005 (160 percent of government revenues and 106 percent of gross international reserves), of which two-thirds was owed to multilateral creditors, mainly the AfDB Group and the Arab Bank for the Economic Development of Africa (BADEA). External debt service obligations amounted to $7½ million in 2005 (13½ percent of revenues), of which Comoros serviced about half, including full payments to the World Bank and partial payments to the AfDB Group, the Islamic Development Bank, and OPEC in 2005. No debt service was paid to BADEA, the European Investment Bank (EIB), and bilateral creditors.



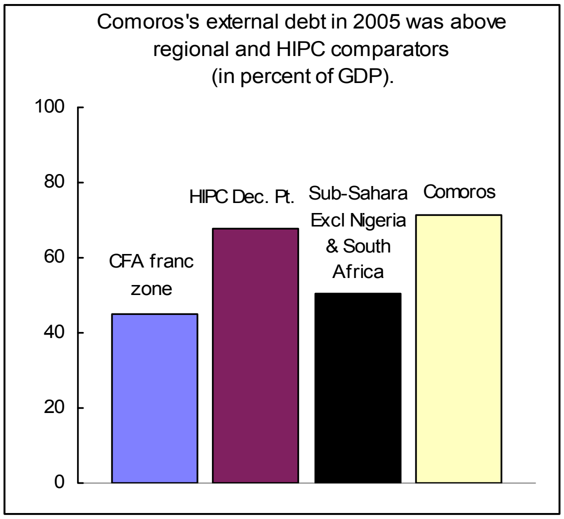
5. **Debt indicators for Comoros are well above HIPC and Low-Income DSA thresholds.** The Bank-Fund low-income DSA framework classifies Comoros as a "poor performer," reflecting the low quality of its policies and institutions.[1] At the end of 2005, the NPV of external debt was well above all policy-dependent thresholds, in particular in relation to exports of goods and services, with debt more than four times above the threshold. Debt service due slightly exceeds the DSA threshold for exports but is below the threshold for revenues.

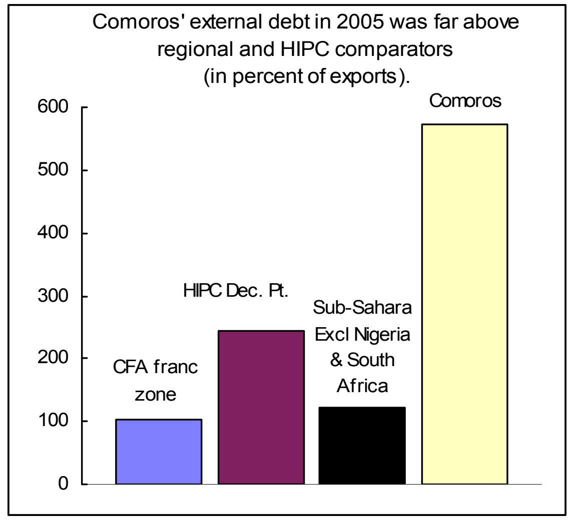
Policy-Dependent External Debt Burden Indicators and Thresholds

	Comoros end-2005	Thresholds: Low income DSA (poor performers)	Thresholds: HIPC
NPV of debt in percent of:			
Exports	419.4	100.0	150.0
GDP	52.3	30.0	…
Revenues	334.2	200.0	250.0
Debt service in percent of			
Exports	16.8	15.0	…
Revenues	13.3	25.0	…

6. **Comoros's external debt is well above regional averages.** In relation to GDP, debt was on a par with African HIPC countries but its debt-to-exports ratio was far higher than most. Debt service due is somewhat below regional averages, but its near-term liquidity problems are more severe than in most other countries, given the amount of its arrears.

[1] See Interim Guidance on the Preparation of Joint Fund-World Bank Debt Sustainability Assessments for Low-Income Countries (2005).





II. Diagnosis, Arrears Clearance, and HIPC and MDRI Assistance

7. **Comoros is to be grandfathered under the Enhanced HIPC initiative.** According to IMF and World Bank Board meetings on September 6 and 7, 2006, Comoros is one of the countries to be grandfathered under the HIPC initiative based on meeting the income and indebtedness criteria at end-2004. Comoros has therefore more time to start an IMF-supported program than envisaged under the previous HIPC sunset clause.

8. **Comoros needs to clear a large stock of arrears before it can benefit from future debt relief.** Before a PRGF arrangement with the IMF, Comoros would need to reach understandings with its creditors on clearing arrears. Clearance might take four forms: (i) a payment by Comoros, using its international reserves, (ii) an arrears rescheduling agreement with the creditor, (iii) debt relief from the creditor, or (iv) third-party donor assistance to help with arrears clearance. While Comoros has a relatively comfortable level of international reserves of about 8 months of imports of goods and services, it can use only a minimal amount of them given the franc zone ceiling on government borrowing from the central bank.

9. **An informal meeting between the authorities and key creditors and donors was held at the IMF during the Spring Meetings in 2006.** Most creditors have since proposed a multiyear rescheduling of arrears, which would keep open the possibility of including part of the arrears in future debt relief. A special case is the AfDB Group, where assistance with arrears clearance is constrained given that the AfDB does not currently classify Comoros as eligible for its post-conflict country facility.[2]

[2] In the AfDB's arrears clearance mechanism, for countries classified as postconflict, one-third of the debt is paid by the country, one-third is paid by a donor, and one-third is cancelled by the AfDB.

10. **The staff performed a debt sustainability analysis for both the baseline and the adjustment scenarios.** The baseline scenario assumes that economic growth stays in line with historical averages (2 percent), economic reform is limited, and inflows of aid are minimal. Comoros would continue to service IDA while arrears with other creditors build.[3]

11. **The adjustment scenario assumes accelerated economic reforms and debt relief.** It allows for higher growth (4 percent over the long term), higher exports, fiscal adjustment, higher external assistance, arrears clearance in 2007, and HIPC and MDRI debt relief in 2009, with interim relief in 2008-09 (Table 1a). It is assumed that there will be no new nonconcessional debt, while concessional borrowing will be relatively low, with most assistance coming in the form of grants.[4]

12. **The specifics of arrears rescheduling can have an important impact on liquidity.** A relatively short arrears rescheduling without a grace period would imply relatively high near-term debt service. For the DSA in the adjustment scenario, it is assumed that arrears are rescheduled over fifteen years for all bilateral and multilateral creditors except the AfDB, where arrears are assumed to be cleared through a combination of own payments and external assistance.[5]

Debt Service Due Under Alternative Arrears Clearance

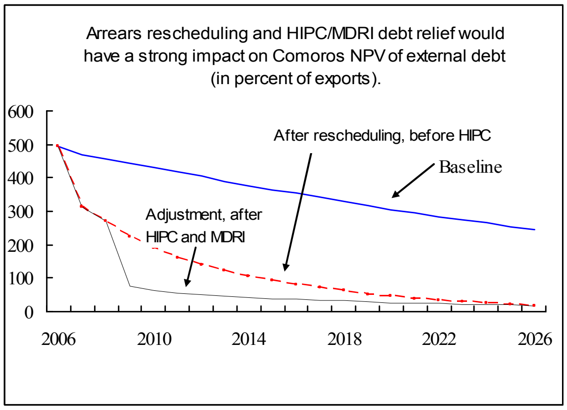
	Average (2007-2009)		Average (2010-2016)	
	Baseline	Adjustment	Baseline	Adjustment
External debt service due				
Scenario I				
In percent of exports	18.1	13.3	5.8	3.8
In percent of revenues	13.8	9.8	4.6	3.1
Scenario II				
In percent of exports	38.5	34.0	3.9	2.6
In percent of revenues	29.5	24.9	3.1	2.1

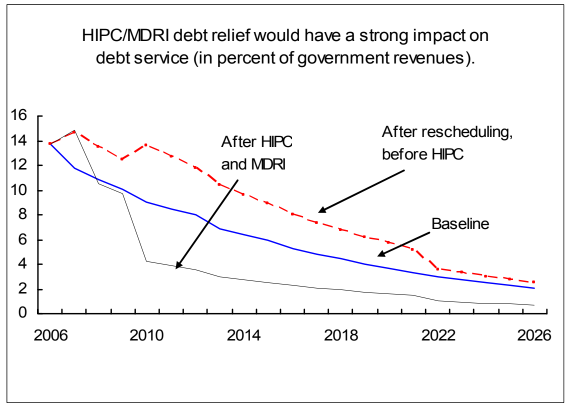
13. **Since two-thirds of Comoros's external debt is owed to the AfDB group and the World Bank, the country could benefit substantially from the MDRI.** Under the MDRI, it is assumed for 2009 that almost all debt to IDA is cancelled, as is debt to the African Development Fund, which is about 71 percent of all debt to the AfDB group.

[3] For further details on assumptions underlying the baseline scenario, see Table 2 and paragraph 15 of the staff report.

[4] For further details on assumptions underlying the adjustment scenario, see Table 2 and paragraph 16-18 of the staff report.

[5] In line with standard practice, all arrears clearance agreements would be explicitly linked to the HIPC initiative to ensure that Comoros's contribution to arrears clearance does not reduce future debt relief and that creditors providing debt relief before the decision point are credited under the initiative.





III. Debt Sustainability Analysis

14. **In the baseline scenario, Comoros's external debt situation remains unsustainable.** With continuous accumulation of arrears and low economic growth, 20 years from now the NPV would still be close to 250 percent of exports—more than twice the policy-dependent low-income DSA threshold and still well above the HIPC threshold. Comoros would effectively remain in default, given its large stock of arrears. Any stress test would worsen the situation further. In the most extreme stress test, defined as a shock to exports in 2007–08, the NPV of external debt would reach almost 800 percent of exports of goods and services (Figure 1).

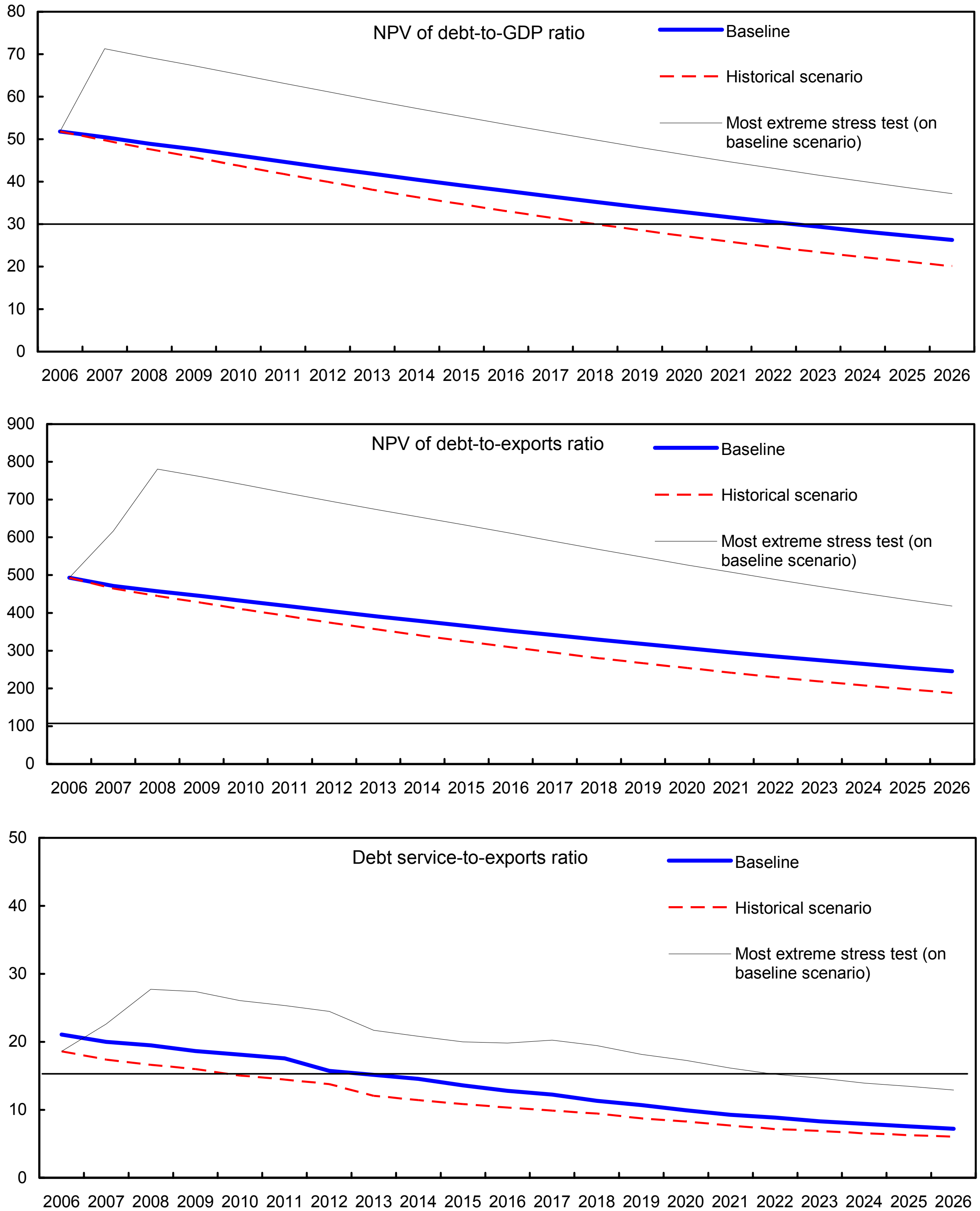
15. **In the adjustment scenario, with HIPC and MDRI debt relief in 2009, external debt indicators would improve substantially** (Table 1a). Arrears clearance in 2007 would sharply reduce the NPV-to-exports ratio, to 311 percent. At the completion point, the NPV of external debt would fall further, to 74 percent of exports, well below the HIPC threshold and also below the policy-dependent low-income DSA threshold. Interim assistance would help decrease the debt service-to-exports ratio to 14 percent in 2008. In 2010, the debt service ratio would become 5 percent of exports.

16. **The debt dynamics in the adjustment scenario would be sustainable in a variety of stress tests** (Table 1b). To see whether HIPC and MDRI debt relief can bring debt to sustainable levels, shocks are applied to the post-debt relief period of 2010 and 2011. Given Comoros's low level of exports, the NPV-to-export ratio is the indicator that is most vulnerable to shocks. For instance, a cumulative decline in exports of 40 percent over the two years, would raise the NPV of debt to 163 percent of exports in 2011 (from 57 percent in the adjustment scenario), and it would take 8 years to reduce the NPV to the policy-dependent threshold of 100 percent of exports (Figure 2). By contrast, the NPV-to-GDP ratio and debt service-to-export ratio would remain well below policy-dependent thresholds.

IV. Conclusion

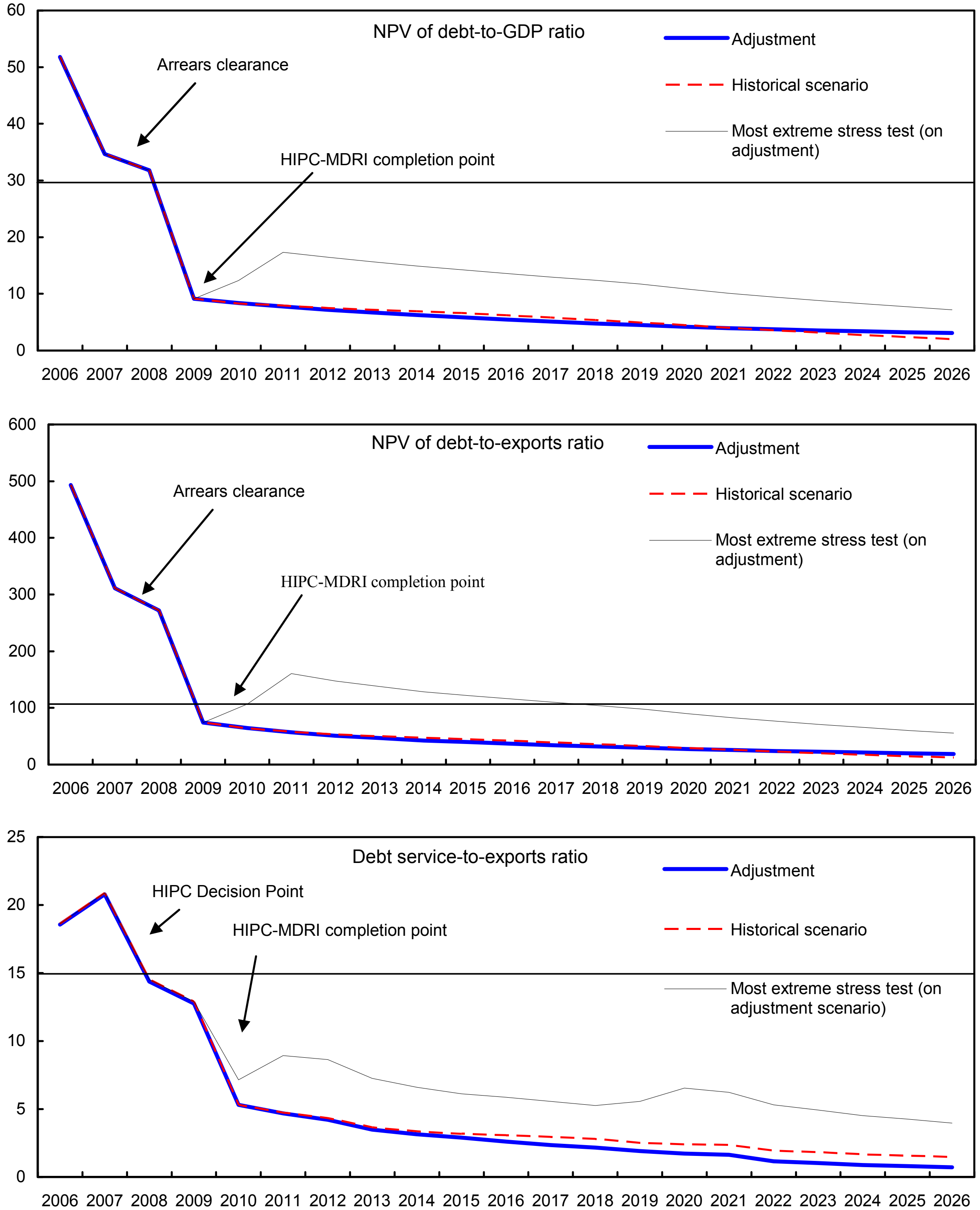
17. **Comoros would remain in debt distress under unchanged policies, but could achieve sustainable debt indicators in an adjustment scenario with higher growth and arrears clearance and HIPC and MDRI debt relief.** The analysis shows that after the completion point debt would be sustainable even under a variety of shocks. A near-term challenge will be to agree on arrears clearance schemes that do not jeopardize the country's liquidity position yet open the way for a PRGF-supported arrangement and HIPC and MDRI debt relief.

Figure 1. Comoros: Indicators of Public and Publicly Guaranteed External Debt
Under the Baseline and Alternative Scenarios, 2006-2026
(In percent)



Source: Staff projections and simulations.

Figure 2. Comoros: Indicators of Public and Publicly Guaranteed External Debt
Under the Adjustment and Alternative Scenarios, 2006-2026
(In percent)



Source: Staff projections and simulations.

Table 1a. Comoros: External Debt Sustainability Framework, Adjustment Scenario, 2006-2026 1/
(In percent of GDP, unless otherwise indicated)

	Actual	Historical	Standard	Projections									
	2005	Average 6/	Deviation 6/	2006	2007	2008	2009	2010	2011	2006-11 Average	2016	2026	2012-26 Average
External debt (nominal) 1/	**71.5**	**91.1**	**11.3**	**70.5**	**58.6**	**52.6**	**16.4**	**15.5**	**13.9**	**37.9**	**8.1**	**2.6**	**6.4**
o/w public and publicly guaranteed (PPG)	71.5	91.1	11.3	70.5	58.6	52.6	16.4	15.5	13.9	37.9	8.1	2.6	6.4
Change in external debt	-6.6	...	...	-0.9	-12.6	-5.9	-36.2	-0.9	-1.6	-9.7	-0.9	-0.3	-0.8
Identified net debt-creating flows	1.5	...	...	3.2	3.3	2.7	2.7	3.9	3.2	3.2	3.8	4.5	4.1
Non-interest current account deficit	**2.6**	**3.6**	**6.5**	**3.9**	**5.5**	**5.5**	**5.3**	**5.3**	**4.4**	**5.0**	**4.9**	**5.3**	**5.1**
Deficit in balance of goods and services	22.2	19.7	3.8	26.8	27.3	26.7	25.9	24.9	23.5	25.8	21.9	18.7	21.0
Exports	12.5	14.9	2.5	10.5	11.1	11.7	12.3	13.0	13.7	12.1	14.9	16.4	15.3
Imports	34.7	34.6	4.3	37.3	38.4	38.4	38.2	38.0	37.2	37.9	36.8	35.1	36.3
Net current transfers (negative = inflow)	-19.5	-14.5	4.3	-22.9	-21.8	-21.1	-20.4	-19.5	-18.9	-20.8	-17.0	-13.4	-15.9
Other current account flows (negative = net inflow)	-0.1	-0.8	0.4	0.0	0.0	0.0	-0.1	-0.2	-0.2	-0.1	-0.1	0.0	-0.1
Net FDI (negative = inflow)	**-0.5**	**-0.4**	**0.2**	**-0.5**	**-0.7**	**-0.7**	**-0.7**	**-0.8**	**-0.8**	**-0.7**	**-0.8**	**-0.8**	**-0.8**
Endogenous debt dynamics 2/	**-0.6**	...	...	**-0.2**	**-1.6**	**-2.1**	**-1.9**	**-0.6**	**-0.5**	**-1.1**	**-0.3**	**-0.1**	**-0.2**
Contribution from nominal interest rate	0.7	...	...	0.6	0.4	0.3	0.3	0.1	0.1	0.3	0.0	0.0	0.0
Contribution from real GDP growth	-3.3	...	...	-0.9	-2.0	-2.4	-2.2	-0.7	-0.6	-1.5	-0.3	-0.1	-0.3
Contribution from price and exchange rate changes	2.0	...	...	…	…	…	…	…	…	...	…	…	
Residual (3-4) 3/	**-8.1**	...	...	**-4.0**	**-15.8**	**-8.6**	**-38.9**	**-4.9**	**-4.7**	**-12.8**	**-4.8**	**-4.8**	**-4.8**
o/w exceptional financing	0.0	...	...	0.0	-21.3	0.0	-32.5	0.0	0.0	-9.0	0.0	0.0	0.0
NPV of external debt 4/	52.3	...	...	51.8	34.7	31.8	9.1	8.4	7.8	23.9	5.5	3.1	4.7
In percent of exports	419.4	...	...	493.2	310.9	271.8	74.0	64.5	56.7	211.9	36.8	18.7	31.4
NPV of PPG external debt	**52.3**	...	...	**51.8**	**34.7**	**31.8**	**9.1**	**8.4**	**7.8**	**23.9**	**5.5**	**3.1**	**4.7**
In percent of exports	419.4	...	...	493.2	310.9	271.8	74.0	64.5	56.7	211.9	36.8	18.7	31.4
Debt service-to-exports ratio (in percent)	16.8	26.5	12.7	18.6	20.8	14.4	12.8	5.3	4.7	12.7	2.6	0.7	2.0
PPG debt service-to-exports ratio (in percent)	16.8	...	...	18.6	20.8	14.4	12.8	5.3	4.7	12.7	2.6	0.7	2.0
Total gross financing need (billions of U.S. dollars)	0.0	...	...	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0
Non-interest current account deficit that stabilizes debt ratio	9.2	...	...	4.8	18.1	11.5	41.5	6.2	6.0	14.7	5.8	5.6	5.8
Key macroeconomic assumptions													
Real GDP growth (in percent)	4.2	2.5	1.6	1.2	3.0	4.5	4.5	4.5	4.0	3.6	4.0	4.0	4.0
GDP deflator in US dollar terms (change in percent)	-2.5	3.4	11.6	3.4	3.0	3.0	3.0	3.0	3.0	3.1	3.0	3.0	3.0
Effective interest rate (percent) 5/	0.9	1.0	0.2	0.9	0.7	0.6	0.6	0.7	0.6	0.7	0.5	0.3	0.4
Growth of exports of G&S (US dollar terms, in percent)	0.2	2.9	19.8	-11.9	12.6	13.0	13.4	13.6	12.6	8.9	7.8	8.5	8.4
Growth of imports of G&S (US dollar terms, in percent)	8.4	4.4	15.5	12.5	9.3	7.4	7.1	7.0	5.0	8.0	6.5	6.7	6.7
Grant element of new public sector borrowing (in percent)	...	...	...	56.9	56.9	56.9	56.9	56.9	56.9	56.9	56.9	56.9	56.9
Memorandym item:													
Nominal GDP (billions of US dollars)	0.4	...	...	0.4	0.4	0.4	0.5	0.5	0.5	...	0.8	1.5	...

Source: Staff simulations.

1/ Includes both public and private sector external debt.
2/ Derived as [r - g - r(1+g)]/(1+g+r+gr) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and r = growth rate of GDP deflator in U.S. dollar terms.
3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.
4/ Assumes that NPV of private sector debt is equivalent to its face value.
5/ Current-year interest payments devided by previous period debt stock.
6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 1b. Comoros: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2006-26
(Adjustment scenario)

		Projections							
	2006	2007	2008	2009	2010	2011	2012	**2016**	2026
NPV of debt-to-GDP ratio (in percent)									
Adjustment	52	35	32	9	8	8	7	**5**	3
A. Alternative Scenarios									
A1. Key variables at their historical averages in 2007-26 1/	52	35	32	9	8	8	8	6	2
A2. New public sector loans on less favorable terms in 2007-26 2/	52	35	32	10	9	8	8	**7**	5
B. Bound Tests									
B1. Real GDP growth at historical average minus one st. deviation in 2010-11	52	35	32	9	9	8	8	**6**	3
B2. Export value growth at historical average minus one st. deviation in 2010-11 3/	52	35	32	9	10	12	11	**9**	5
B3. US dollar GDP deflator at historical average minus one st. deviation in 2010-11	52	35	32	9	9	10	9	**7**	4
B4. Net non-debt creating flows at historical average minus one st. deviation in 2010-11 4/	52	35	32	9	10	12	11	**9**	5
B5. Combination of B1-B4 using one-half st. deviation shocks	52	35	32	9	12	17	16	**14**	7
B6. One-time 30 percent nominal depreciation relative to the baseline in 2010 5/	52	35	32	9	12	11	10	**8**	4
NPV of debt-to-exports ratio (in percent)									
Adjustment	493	311	272	74	64	57	51	**37**	19
A. Alternative Scenarios									
A1. Key variables at their historical averages in 2007-26 1/	493	311	272	74	64	58	53	42	12
A2. New public sector loans on less favorable terms in 2007-26 2/	493	313	275	78	69	62	56	**44**	28
B. Bound Tests									
B1. Real GDP growth at historical average minus one st. deviation in 2010-11	493	311	272	74	64	57	51	**37**	19
B2. Export value growth at historical average minus one st. deviation in 2010-11 3/	493	311	272	74	104	163	149	**115**	56
B3. US dollar GDP deflator at historical average minus one st. deviation in 2010-11	493	311	272	74	64	57	51	**37**	19
B4. Net non-debt creating flows at historical average minus one st. deviation in 2010-11 4/	493	311	272	74	81	85	78	**60**	29
B5. Combination of B1-B4 using one-half st. deviation shocks	493	311	272	74	107	160	147	**115**	56
B6. One-time 30 percent nominal depreciation relative to the baseline in 2010 5/	493	311	272	74	64	57	51	**37**	19
Debt service ratio (in percent)									
Adjustment	19	21	14	13	5	5	4	**3**	1
A. Alternative Scenarios									
A1. Key variables at their historical averages in 2007-26 1/	19	21	15	13	5	5	4	3	1
A2. New public sector loans on less favorable terms in 2007-26 2/	19	21	15	13	5	5	4	**3**	2
B. Bound Tests									
B1. Real GDP growth at historical average minus one st. deviation in 2010-11	19	21	15	13	5	5	4	**3**	1
B2. Export value growth at historical average minus one st. deviation in 2010-11 3/	19	21	15	13	7	9	9	**6**	4
B3. US dollar GDP deflator at historical average minus one st. deviation in 2010-11	19	21	15	13	5	5	4	**3**	1
B4. Net non-debt creating flows at historical average minus one st. deviation in 2010-11 4/	19	21	15	13	5	5	5	**3**	2
B5. Combination of B1-B4 using one-half st. deviation shocks	19	21	15	13	6	7	7	**5**	4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2010 5/	19	21	15	13	5	5	4	**3**	1
Memorandum item:									
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	56	56	56	56	56	56	56	**56**	56

Source: Staff projections and simulations.

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

UNION DES COMORES

Unité – Solidarité – Développement

September 19, 2006

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Rato,

The Union of the Comoros held its presidential elections in April and May 2006, leading to the first democratic power transfer in over a decade and bringing to an end the long process of national reconciliation started in 2001. The overwhelming support for President Sambi and his message of change mean that the new Union government finds itself with a strong popular mandate across all islands, but also has the heavy responsibility of meeting the aspirations of peace and prosperity of all Comorians. Accordingly, we attach the highest priority to improving economic and social conditions as envisioned in Comoros's 2005 Interim Poverty Reduction Strategy Paper (I-PRSP), which the new government fully endorses and will strive to implement.

We view the support of Comoros's international partners as crucial to the success of our social and economic policies. The IMF in particular has supported the authorities' efforts to conduct sound economic policies through an intensive policy dialogue and technical assistance. Comoros embarked in 2005 on a Staff-Monitored Program (SMP), which helped preserve economic stability in the face of severe external shocks, although several important program objectives were not achieved. The SMP was extended through June 2006 to build a track record of policy implementation that would allow Comoros to enter a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF), which in turn could pave the way for eventual debt relief under the enhanced HIPC Initiative and MDRI.

Unfortunately, budget execution in the first half of this year derailed in the electoral context. Government revenues fell well short of the program target, reflecting governance problems in customs administration and state enterprises. Revenues were diverted away from the established treasury accounts and the interisland revenue-sharing mechanism broke down in a climate of mistrust. In addition, spending significantly exceeded program targets. As a result, salary and external arrears increased sharply, government borrowing increased more than envisaged, and the financial position of public enterprises deteriorated markedly. Structural reforms were put on hold as it became clear that political change was imminent.

The new government moved quickly to redress the situation. The first priority was to reestablish trust and cooperation between the Union and the three island governments in the conduct of public finances. To that effect, the mechanism for sharing fiscal revenues was revised in June with a view to ensuring full transparency and self-compliance. Simultaneously, the government appointed four special enquiry commissions (on customs and tax administration and on the fuel and rice parastatals) to assess the full extent of revenue underperformance and address the underlying causes. To make clear that corrupt practices and political interference will no longer be tolerated, legal action has been taken in cases where misconduct is suspected, including the detention of former officials and state enterprise managers.

Starting in July, we have implemented a package of emergency measures in close coordination between the Union and island governments:

- A supplementary budget for the Union and three island governments was approved by parliament on August 23. It aims to bring public finances back in line with the thrust of the original 2006 budget and SMP objectives by introducing measures to boost revenues and achieve the flow targets for the second half of the year. It also significantly curtails expenditures in the second half of the year. A key objective is to fully reverse the domestic arrears accumulation of the first half of the year, although this will require additional donor support.

- To restore revenue collections, the government has (i) replaced most senior managers of the customs administration in the port of Moroni; (ii) begun implementing a new structure for tax and customs administration that ensures transparency and accountability; (iii) strictly prohibited customs clearance without full payment of assessed taxes and duties; (iv) increased the specific rate of the forfeit regime for imported containers; (v) enforced the elimination of customs exemptions not included in the customs code; (vi) restricted the use of offsets for customs payments; and (vii) begun enforcing customs registration and tax settlement of imports by public enterprises, in line with procedures for all other imports.

- To curtail spending, we have consolidated several ministries, eliminated many high-level advisor positions, and curtailed foreign travel for public officials. We also plan to keep discretionary spending to a minimum and reduce administrative positions in all ministries except health and education by 2 percent by yearend, to start reducing the wage bill in order to safeguard resources for health and education.

- To restore the financial viability of public enterprises, we have replaced senior managers and taken steps to ensure that (i) the Union and island governments remain current on their utility bills, (ii) rice imports are based on competitive tenders, and (iii) retail prices for rice and fuel reflect international prices. We are seeking donor support to finance external audits in preparation for wider-ranging reforms.

Looking ahead, the Comorian authorities request a further extension of the SMP through December 2006 to establish the policy implementation record that would allow entering into discussions on a PRGF arrangement before end-2006. The policies set forth in the March 31, 2006, Memorandum of Economic and Financial Policies and the objectives of the 2006 program remain broadly consistent and adequate, and we believe that the corrective actions taken by the new government have laid the foundation for safeguarding the fiscal situation and macroeconomic stability this year. We have updated fiscal targets for the second half of 2006 (Table 1), in line with the revised 2006 budget, and will accelerate efforts to reach understandings with external creditors on arrears clearance. We are also following through on key structural reforms aimed at boosting the capacity of fiscal institutions that had been delayed in the election context (Table 2). Much more needs to be done to strengthen public institutions and boost economic growth, and we intend to intensify structural reforms in 2007, with the support of our international development partners.

Throughout the duration of the program, the government will consult with the IMF Managing Director, on its own initiative or at your request, to discuss the economic and financial policies of the Union of the Comoros. We will provide the staff with information it requests for monitoring progress in program implementation.

Sincerely yours,

/s/	/s/
Hassani Hamadi	Ahamadi Abdoulbastoi
Minister of Finance, Budget, Economy, and Planning, in charge of Employment Promotion	Governor of the BCC

Table 1. Comoros: Quantitative Targets Under the Staff-Monitored Program 1/
January 2006–December 2006
(In millions of Comorian francs, cumulative since the beginning of the year)

	2006							
	March		June		September		December	
	SMP Targets 4/	Actuals	SMP Targets 4/	Prelim.	Indicative Targets 4/	New SMP Targets 5/	Indicative Targets 4/	New SMP Targets 5/
(a) Floor on the domestic primary balance	105	-617	936	-2,188	2,276	-873	1,373	-548
(b) Floor on total domestic revenues	4,650	4,479	11,600	9,656	18,075	16,131	24,400	22,456
(c) Ceiling on the wage bill	3,300	3,247	6,500	6,719	9,650	9,869	12,799	12,900
(d) Ceiling on expenditures made by cash advances (without prior budget commitment)	100	358	200	557	399	657	400	657
(e) Ceiling on the net accumulation of domestic arrears 2/	0	1,060	0	1,348	-300	911	-700	0
(f) Ceiling on new nonconcessional external debt contracted or guaranteed by the state 3/	0	0	0	0	0	0	0	0
(g) Ceiling on new short-term external debt contracted or guaranteed by the state 3/	0	0	0	0	0	0	0	0
(h) Ceiling on accumulation of multilateral external debt service arrears	0	262	0	720	0	720	0	720

1/ Definitions of targets and adjusters are provided in the Technical Memorandum of Understanding (TMU), see Country Report No. 05/77.
2/ Ceilings will be adjusted upward by the amount of the shortfall in budget support relative to the projection of CF 2,104 million assumed for the second half of 2006.
3/ Excluding trade credits.
4/ Based on the January - June 2006 SMP and indicative targets for the remainder of the year, see Country Report No. 06/193.
5/ New targets under SMP extension through December 2006, based on end-June 2006 preliminary outturn.

Table 2. Structural Indicative Targets Under the 2006 SMP and Indicative Reform Agenda for 2007

Sector	Measure	Revised Time Frame	Status
A. Structural Indicative Targets Under the SMP (originally for the period January - June 2006)			
Budget reform	Establish accounting unit to compile and consolidate budget execution data from the Union and island governments (April 2006).	Oct. 2006	Legal framework has been prepared.
	Conduct monthly meetings of the budgetary committee comprising representatives of the Union and all three islands (continuous from April 2006).	Continuous from June 2006	On track since June 2006.
	Start issuing monthly reports on budget execution by the Union and islands to all Ministries of Finance, within 45 days after the end of each month (continuous from April 2006).	Continuous from June 2006	On track since June 2006.
	Start issuing monthly reports on public external debt service by creditor to the Union Ministry of Finance, with breakdown of amortization and interest accrued and paid (continuous from April 2006).	Continuous from Sep. 2006	On track since June 2006.
	Start compiling on a quarterly basis social expenditures for Union and island governments, within 2 months after the end of a quarter (continuous from May 2006).	Mar. 2007	In preparation.
Revenue reform	Create a large taxpayers unit responsible for registration, management, arrears collection, and audit of all large enterprises on the three islands (April 2006).	Nov. 2006	Legal framework under preparation.
	Perform a census of enterprises with revenues above CF 20 millions on the three islands (April 2006).	Oct. 2006	Completed in Grande Comore. Under preparation in Anjouan and Moheli.
Private sector development	Submit investment law to parliament that includes the introduction of a one-stop shop for investors and provides for legal procedures that give investors recourse to the courts (April 2006).	Dec. 2006	Re-drafting in progress, based on IMF/World Bank comments.
	Adopt strategy for introducing greater competition and private sector involvement in state-owned enterprises, including for telecommunications and hydrocarbons (Sep 2006).	Dec. 2006	Discussions with IFC/World Bank ongoing.
B. Additional SMP Measures For July-December 2006			
Revenue reform	Implement new revenue sharing accounts, based on the *Proces Verbal* of the four Ministers of Finance.	July 2006	Done (July).
	Prevent imports clearing customs before full payment of assessed taxes and duties (abolishing *provisional* and *partial* settlement).	July 2006	Done (August).
	Implement new structure for revenue administration at the Union and island levels, based on the *Proces Verbal* of the four Ministers of Finance.	Oct. 2006	In preparation.
	Enforce customs registration and tax settlement of imports by state enterprises, in line with procedures for all other imports.	Oct. 2006	In preparation.
	Enforce elimination of all discretionary customs exemptions.	Aug. 2006	Done (August).
	Begin reporting of detailed monthly customs data of each island to the general customs directorate, within 15 days after the end of each month.	Continuous from Aug. 2006	Done (August).
	Restrict the use of offsets for customs payments.	Aug. 2006	Done (August).
	Increase the specific rate of the *forfeit* regime for imported containers.	Aug. 2006	Done (August).
C. Indicative Structural Reform Agenda for 2007			
Budget reform	Adopt template for a new chart of accounts for the public sector.		
	Report arrears by economic type and keep an auxiliary recording of actual cash payments by major category.		
	Include a budget estimate for tax expenditure related to customs exemptions in the annual budget law and monitor on a monthly basis the cost of costums exemptions.		
	Implement new budget nomenclature for health and education.		
Revenue reform	Simplify tax and customs code, based on uniform ad valorem import tariffs; a uniform ad valorem consumption tax (for imports—paid at customs; for domestic goods—paid by producer); excise taxes on key commodities, including fuel and luxury products.		
	Implement customs software on all islands.		
	Strengthen valuation of imports at customs, including by ensuring external valuation on all islands.		
Expenditure reform	Complete computerization of civil servant payment roster and staff the administration to monitor and control wage payments.		
	Adopt organic frameworks for Union and island ministries.		
Statistics	Restructure the statistics office to expand its responsibilities to include the compilation and dissemination of Union and island-level data.		
	Develop a multi-sector action plan for enhancing the availability of economic and social statistics.		
Financial sector	Extend banking supervision to expansion of financial services by the post office, including on-site supervision.		
	Extend banking supervision to entry of new banks, in line with MFD recommendations, including by adopting MoUs with home supervisors of foreign banks.		
	Extend banking supervision to all microfinance institutions.		
Private sector development	Adopt strategy for introducing greater competition and private sector involvement in state-owned enterprises, including for telecommunications and hydrocarbons.		
	Adopt an action plan to reduce financial losses and arrears of public electricity company.		
	Promulgate new investment code.		

INTERNATIONAL MONETARY FUND

UNION OF THE COMOROS

Annexes to the Staff Report for the 2006 Article IV Consultation and Review and Extension of the Staff-Monitored Program

September 27, 2006

Contents Page

Annex 1: Fund Relations

(As of August 31, 2006)

A. Financial Relations

I. Membership Status: Joined September, 21,1976; Article VIII

II. General Resources Account:	**SDR Millions**	**% Quota**
Quota	8.90	100.00
Fund holdings of currency	8.36	93.91
Reserve position in Fund	0.54	6.11

III. SDR Department:	**SDR Millions**	**% Allocation**
Net cumulative allocation	0.72	100.00
Holdings	0.01	2.16

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR millions)	Amount Drawn (SDR millions)
SAF	06/21/91	06/20/94	3.15	2.25

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

	Forthcoming				
	2006	2007	2008	2009	2010
Principal	...	...	...	...	...
Charges/interest	0.01	0.03	0.03	0.03	0.03
Total	0.01	0.03	0.03	0.03	0.03

VII. Implementation of HIPC Initiative: Not applicable

VIII. Implementation of MDRI Assistance: Not applicable

B. Nonfinancial Relations

IX. Exchange Rate Arrangements: The currency of the Comoros is the Comorian franc, which is pegged to the euro at €1 = CF 492. Comoros has accepted the obligations of Article VIII, Sections 2(*a*), 3, and 4, and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

X. Last Article IV Consultation: The 2005 Article IV consultation was concluded by the Executive Board on July 18, 2005 (Country Report No. 05/299). Comoros is on the standard 12-month cycle.

XI. Technical Assistance, 2003-06

Department	**Dates**	**Subject**
MFD	July 2003	Mission to review the role of the central bank in banking supervision and to evaluate technical assistance needs
MFD	Sep.– Oct. 2003	Mission to review the planned resumption of activities by the Comoros Development Bank, the possible opening of a postal bank, and the supervision of microfinance institutions
MFD	Feb. 2004	AML/CFT
MFD	Feb. 2004	Internal audit
MFD	March 2004	Bank supervision
	October 2004	
	March 2005	
	December 2005	
MFD	April 2006	Multitopic TA assessment
FAD	August 2005	Tax policy
FAD	Jan. – Feb. 2006	Tax administration
STA	September 2005	Government finance statistics
FAD	February 2006	Tax policy

XII. Resident Representative

None. A resident representative post established in September 1991 was closed in December 1995.

ANNEX 2: RELATIONS WITH THE WORLD BANK GROUP[1]

1. Since the World Bank became active in the country in 1976, the Bank Executive Board has approved 19 IDA credits totaling US$132.5 million to support Comoros. The only currently active project became effective on September 29, 2004. This community-based Social Services Project (SSP) seeks to maintain basic service delivery and address the most urgent health and water needs. The SSP is a four-year operation in the amount of US$13.3 million. Current Bank support strategy as presented to the Board of Directors in March 2004 has two objectives: (i) maintaining basic social services, and (ii) supporting the process of national reconciliation and facilitating the transition to viable institutions.

2. The Bank is preparing an update of this strategy that is scheduled to go to the Board in December 2006. The new strategy will align with the current one but put more emphasis on strengthening public sector capabilities. The strategy will propose two lending operations totaling USD6.8 million for the period FY07-09: (i) a supplement to the SSP; and (ii) a Public Sector Capacity Building and Governance Project.

3. Since the national reconciliation agreement was signed in December 2003, the Bank has worked closely with the Fund to support the transition in Comoros, concentrating notably on improving economic management and strengthening the institutions responsible for revenue collection and budget execution. The Bank will continue to work closely with the Fund in these areas, and in monitoring and facilitating I-PRSP implementation.

4. The IFC does not have any activities in Comoros, and the country has not yet joined the MIGA. The Government of Comoros requested technical advice from the IFC on possible privatization of the oil and telecom companies. The IFC Advisory Services conducted a mission to Comoros on March 24-29, 2006. The mission met with stakeholders and agreed it could support the authorities in defining their strategy for these two companies; it submitted an offer for advisory services, which requires a financial contribution from the Comoros authorities to demonstrate their readiness to move the process forward. The World Bank Institute (WBI) is planning a leadership seminar late in 2006 for Comorian authorities as part of a LICUS grant. If the seminar proves successful, WBI will consider followup activities.

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[1] Prepared by the staff of the World Bank on September 6, 2006.

FINANCIAL RELATIONS WITH THE WORLD BANK

IDA Active Lending Operations in Comoros as of September 6, 2006
(In millions of U.S. dollars)

Purpose	Approved	Committed	Disbursed
	(Fiscal year)	(Less cancellations)	
Number of closed credits (18)	119.1	106.1	109.2[2]
Active credits			
Services Support Project	FY2004	13.3	5.7
Total active		**13.3**	**5.7**

Source: World Bank Client Connection.
[1] Disbursements suspended because of arrears.

IDA Loans and Debt Service CY 1997–CY 2006, as of August 31, 2006
(In millions of U.S. dollars)

	CY 97	CY 98	CY 99[1]	CY 00	CY 01	CY 02	CY 03	CY 04	CY 05	CY 06[2]
IDA net disbursements	4.8	2.8	(0.5)	1.3	10.7	11.1	7.3	1.3	0.6	0.4
Gross disbursements	5.2	3.1	0.0	2.1	11.5	12.1	8.6	3.2	2.6	1.7
Repayments	0.4	0.2	0.5	0.7	0.8	1.1	1.2	1.8	2.0	1.3
Interest payments	0.5	0.3	0.6	0.7	0.5	0.6	0.7	0.9	0.8	0.6

Source: World Bank Client Connection
[1] Disbursements suspended because of arrears.
[2] From January 1 to August 31, 2006.

[2] Disbursed amount is more than approved and committed amounts because of exchange rate depreciation of US$ against SDR.

ANNEX 3: STATISTICAL ISSUES

Existing data are insufficient for effective surveillance due to severe capacity constraints. The statistical database is deficient in all sectors because of inadequate staffing and funding, as well as lack of integration of island-based data. Comoros does not participate in the General Data Dissemination System (GDDS). A Statistics Department GDDS metadata development mission is schedule for January 2007.

National accounts data and prices

Data shortcomings are particularly severe in the area of national accounts. Since basic data are not available in a number of areas, the aggregate GDP estimate are mostly based on crude assumptions and extrapolations of partial coverage. The estimates of GDP at current prices are compiled using outdated benchmark data. Due to lack of funding and staffing, there have been no survey-based national accounts since 1995, when one was prepared with UNDP assistance, and to date there has been no survey at all on manufacturing. In 2004, with the support of donors, a new population census and surveys on subsistence agriculture and households were completed. These surveys have neither been fully processed or updated. An AFR mission in July 2006 helped the authorities improve GDP estimates for 2001–05.

The weights used to compile the consumer price index (CPI) are based on an outdated survey from the late 1980s and is compiled irregularly across the islands. Most price data are collected only for Moroni, the country's capital. Price compilation and quality control are conducted mainly by only one person.

Fiscal data

Classification of budgetary data is often not consistent over time or across the islands. In particular, problems arise in data on domestic arrears, external debt, and external support including its investment spending components. The latest data published in the *Government Finance Statistics (GFS) Yearbook* for Comoros are for 1987; the *International Financial Statistics* (*IFS)* country page does not show any government finance data.

In August/September 2005, a GFS technical assistance mission found that the public chart of accounts is inadequate to accurately record the execution of the budget. Also, a standardized table on outstanding public debt has not yet been compiled. In order to address existing problems, the mission recommended the creation of a committee to reform the public chart of accounts and strengthening of the coordination of accounting methods used by the various islands. The mission encouraged the authorities to set up a harmonized information system for budgetary and accounting operations. The mission's report also proposes various methodological improvements as well as an enhancement of the dissemination of central government operations and public debt data.

External sector statistics

The Central Bank of Comoros (BCC) compiles balance of payments data. With technical assistance from an STA expert who visited Comoros in April 2005, the BCC was able to get ready to adopt the IMF *Balance of Payments Manual*, 5th edition (*BPM5).* The STA expert also helped the authorities to prepare a work plan to improve compilation of data on the balance of payments and international investments. As a result, preliminary annual estimates are now available, though not yet published, for 2003–05. However, the latest data on the balance of payments are available to STA only through 1995.

Despite some improvement, balance of payments data remain inadequate, mainly due to lack of adequate staff and financial resources to do the compiling. A single economist is responsible for compiling balance of payments information. Improvement is needed in data validation and data coverage, particularly for trade, nonregistered trade, services, and foreign direct investment data. Data on trade are also deficient because of poor practices in Customs data transmission. An AFR mission in July 2006 helped the authorities strengthen balance of payments data for 2001–05, based on more information on goods and services trade and a more advanced methodology for estimating inflows of emigrants' remittances.

Monetary data

The BCC produces adequate monetary statistics on its own accounts, for the only commercial bank active in Comoros, and for two microcredit operators. The CFA franc zone arrangement has established accounting and prudential standards that prevent data disruptions. A major shortcoming is the absence of data on the large amount of euro cash in circulation.

In May 2006, the BCC reported monetary data to STA by using the Standardized Report Forms (SRFs) for the assets and liabilities of the central bank (1SR), other depository corporations (2SR), other financial corporations (4SR), as well as for monetary aggregates (5SR). Monthly monetary data in the SRF format are available for the period December 2005–April 2006.

Income distribution data and social indicators

Some progress was made with collecting income-distribution statistics and social welfare indicators when the I-PRSP was being prepared in 2003–04. However, since then coverage has remained limited and there has been no monitoring of progress towards the MDGs.

Technical assistance missions in statistics (1986-2005)

Subject	Staff Member	Date
Government finance statistics	G. Rousselot	August 2005
Balance of payments and international investment position statistics	M. Dessart	March-April 2005
Money and banking statistics	G. Raymond	July 1997
Balance of payments statistics	Daniel Daco	May-June 1988
Money and banking statistics	Thiet T. Luu	October 1987
Government finance statistics	Vincent Marie	June 1986

Forthcoming technical assistance

In 2005, the authorities requested a Statistics Department (STA) multitopic technical assistance mission with a view to help preparing a thorough revamping of the statistical system. STA has also been asked to provide technical assistance in the areas of national accounts, external debt, and the General Data Dissemination System (GDDS).

Comoros: Table of Common Indicators Required for Surveillance

(As of September 27, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange rates	Current	Current	D	D	M
International reserve assets and reserve liabilities of the monetary authorities[1]					
Reserve/base money	June 2006	July 2006	M	Q	Q
Broad money	June 2006	July 2006	M	Q	Q
Central bank balance sheet	June 2006	July 2006	M	Q	Q
Consolidated balance sheet of the banking system					
Interest rates[2]	June 2006	July 2006	C	C	M
Consumer Price Index	June 2006	July 2006	M	I	I
Revenue, expenditure, balance and composition of financing[3] – General government[4] – Union government and three island governments	June 2006	July 2006	M	I	I
Revenue, expenditure, balance and composition of financing[3]– Central government	Data for the Union government only would be of limited relevance without data for the three island governments; they are not produced separately				
Central government and central government–guaranteed debt[5]	June 2006	July 2006	A	I	I
External current account balance	2005	July 2006	A	I	I
Exports and imports of goods and services	2005	July 2006	Q	I	I
GDP/GNP	2005	July 2006	A	I	I
Gross external debt	2005	July 2006	A	I	I

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, and rates on treasury bills, notes, and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extrabudgetary funds, and social security funds), and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A); irregular (I); reported when there are changes (C).

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 06/126
FOR IMMEDIATE RELEASE
October 30, 2006

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

IMF Executive Board Concludes 2006 Article IV Consultation with The Union of the Comoros

On October 13, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with The Union of the Comoros.[1]

Background

Economic growth has been weak and narrowly based, with average annual real GDP growth of 2¾ percent for 2001-05, well below the regional average. The poor growth record reflects some of the country's inherent disadvantages, such as the small size of the local market and the very high transport costs, but also a poor investment climate. Economic activity remains largely confined to subsistence agriculture, production of three export crops, import-related commerce, and government services. Fishing and tourism are well below potential; manufacturing is almost nonexistent.

Although almost half the population lives in poverty, other social indicators are more favorable than in most of sub-Saharan Africa mainly because of the low prevalence of HIV/AIDS.

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

With a very narrow export base, the economy is highly dependent on emigrants' remittances, which have financed consumer imports and provided a buffer against terms of trade shocks. Political instability and frequent interisland tensions that undermined institutional capacity led to a sharp reduction in donor assistance over the last decade. External debt is far above the threshold for the Highly Indebted Poor Countries Initiative (HIPC).

Membership in the franc zone arrangement has contributed to low inflation and limited fiscal deficits. Fiscal policy has been constrained by the large public wage bill, which limits the scope for social expenditure and public investment. Weak fiscal institutions have contributed to the chronic accumulation of expenditure arrears.

In 2005 macroeconomic stability was maintained despite a sharp deterioration in Comoros's terms of trade. Real GDP growth picked up thanks to services and tourism. Inflation was modest and rapid growth in remittances partly offset the sharp deterioration in the external trade balance. Fiscal performance improved in 2005, with an increase in the domestic primary surplus and a net reduction in domestic arrears.

Economic performance worsened in 2006, with a sharp economic slowdown and widening external imbalances. Public finances deteriorated significantly during the run-up to the May 2006 presidential elections. Fiscal revenues declined sharply, in large part due to pre-election governance problems in customs administration and public enterprises. Interisland coordination of fiscal policy was disrupted and expenditures were higher than expected. As a result, budgetary arrears and borrowing from the central bank increased substantially, and the domestic primary balance turned sharply negative.

The new government has taken steps to remedy the deterioration in public finances and restore interisland cooperation. The revenue-sharing mechanism was reinforced by ensuring that all revenues are channeled through a single account. The supplementary budget parliament approved in August contained a range of measures to boost revenues and curtail expenditures. The objective is to limit the full-year primary fiscal deficit to ¼ percent of GDP for the year as a whole while paying down the domestic arrears accumulated in the first half of the year.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. Directors welcomed the peaceful presidential elections in May 2006 as a milestone in the national reconciliation process. They saw the new government's most urgent economic task as correcting the recent deterioration in public finances, while launching a broader medium-term economic reform program to set the conditions for higher economic growth and poverty reduction.

Directors regretted the sharp deterioration in fiscal performance in the months leading up to the presidential elections, which resulted in large deviations from the first-half 2006 targets under the Staff-Monitored Program (SMP). They noted that weak inter-island cooperation and governance problems contributed to significant revenue shortfalls and expenditure overruns, resulting in a sharp accumulation of domestic arrears and debt.

Directors were encouraged by recent actions of the new government to restore inter-island fiscal cooperation, improve governance, curtail spending, and bolster revenue collection. They commended the authorities for making their policies transparent in a supplementary budget for 2006. This package of measures, in conjunction with financial support from donors, should help reduce domestic debt and arrears in the second half of 2006 and achieve a broadly balanced primary fiscal position for the year as a whole. A prudent 2007 budget should avoid new arrears and reallocate expenditure toward social sectors and public investment.

Directors noted that Comoros faces a daunting task of lifting economic growth after decades of stagnation. They welcomed the recent Interim Poverty Reduction and Growth Strategy Paper (I-PRSP), and supported its focus on fostering private-sector led economic growth and improving the provision of public services in the social sectors. To implement the strategy, Directors highlighted the need to enhance the capacity of public institutions, address the unsustainable debt burden, improve external competitiveness, and garner additional donor assistance, in line with pledges made during the December 2005 donor conference.

Directors cited Comoros's weak institutional capacity as a fundamental constraint on its growth and stabilization prospects. Insufficient cooperation between the Union and island governments, in the context of a decentralized fiscal system, had contributed to an excessively large civil service and weak fiscal policy implementation and statistical base. Directors also highlighted the adverse impact of institutional weaknesses on donor support and private sector investment. Going forward, they stressed that intensified inter-island cooperation and technical assistance, in particular in the fiscal area, will be essential for building institutions that can promote macroeconomic stability and growth.

Directors expressed concern about Comoros's lack of external competitiveness, and stressed the need for wide-ranging structural reforms. The recent real exchange rate appreciation and terms of trade shocks had contributed to widening external imbalances, although this mainly reflected structural factors. Directors noted that large inflows of remittances had so far kept the current account deficit in the moderate range, but stressed the need for vigilance and fiscal restraint. Directors recommended reforms to improve the investment climate, develop the financial sector, and reform public monopolies. In particular, Directors welcomed the authorities' plans to strengthen governance and introduce a new investment code. Improvements to transport and communications infrastructure will be critical for attracting foreign investors. Directors urged the authorities to accelerate efforts to prepare for greater competition and private ownership in sectors currently dominated by inefficient public monopolies, coordinating closely with the World Bank and other donors. They also underscored the importance of financial sector development for private sector growth and economic diversification, including the prospective entry of new banks.

Directors noted that successful implementation of the SMP in the second half of 2006 could open the way for a possible consideration of a PRGF arrangement as soon as practicable. To this end, they stressed the importance of focusing current policy efforts on restoring revenue collection, containing non-priority spending, and strengthening fiscal institutions to ensure that any PRGF-supported economic program would be rooted in sound fiscal policies. Directors acknowledged that the authorities have set ambitious program targets and that implementation risks will remain high. Directors welcomed the recent progress made by Comoros in reaching understandings with official creditors on clearing its large external arrears ahead of any PRGF arrangement, which in turn is a prerequisite for the eventual HIPC and MDRI debt relief necessary to reduce debt to a manageable level.

It is expected that the next Article IV consultation with the Union of the Comoros will be held on the standard 12-month cycle.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2006 Article IV Consultation with The Union of the Comoros is also available.

Comoros: Selected Economic and Financial Indicators, 2003-06

	2003	2004	2005	2006 Proj.
	(Annual changes, in percent)			
National income and prices				
Real GDP	2.5	-0.2	4.2	1.2
Real GDP per capita	0.3	-2.3	2.1	-0.8
Nominal GDP (in millions of CF)	141,437	143,596	153,112	158,114
Consumer prices (annual average)	3.8	4.5	3.6	3.8
Money and credit				
Net foreign assets	-4.8	-1.6	0.9	-0.6
Domestic credit	-3.4	-3.6	9.0	-4.6
Broad money	-1.1	-6.3	3.1	-1.1
	(In percent of GDP unless otherwise indicated)			
Investment and savings				
Investment	12.9	11.1	9.3	10.2
Public	5.4	4.4	4.5	5.3
Private	6.7	6.7	4.8	4.9
Gross national savings	7.2	6.5	6.0	5.6
Public	1.9	2.7	4.6	3.8
Private	5.3	3.8	1.4	1.9
Government operations				
Revenues	15.8	15.6	15.7	14.2
Grants	2.2	2.8	4.3	6.4
Expenditures	21.5	20.1	19.9	22.1
Of which: current expenditure	16.1	15.7	15.4	16.8
Change in arrears				
External interest	0.7	0.5	0.4	0.4
Domestic	0.9	0.8	-0.5	0.0
Primary balance	0.5	-0.5	1.1	-0.3
Overall balance				
Commitment basis, including grants	-3.4	-1.7	0.1	-1.5
Cash basis, including grants	-1.9	-0.3	-0.5	-1.1
External sector				
Exports of goods and services	15.8	12.7	12.5	10.5
Imports of goods and services	31.8	32.6	34.7	37.3
Current account balance	-3.1	-2.8	-3.3	-4.5
Excluding official and private transfers	-16.5	-20.5	-22.9	-27.4
External debt (end of year)	81.1	80.5	71.5	70.5
Of which: arrears	23.4	24.1	24.9	25.3
NPV, percent of exports of goods & services	...	...	419.4	493.2
External debt service				
In percent of exports of goods & services	14.0	17.6	16.8	18.6
In percent of government revenues	14.0	14.3	13.3	13.7
Gross international reserves (end of year)				
In millions of U.S. dollars	97.2	92.7	87.1	87.4
In months of imports of goods & services	11.3	9.4	8.2	7.3
Real effective exchange rate (2000=100)	116.8	123.6	126.0	...
Terms of trade (percent change)	75.6	-34.2	-43.9	-6.0
Exchange rate CF/US$ (annual average)	437.6	395.7	415.0	...

Sources: Comorian authorities and IMF staff estimates and projections.

Statement by Damian Mañe on Union of the Comoros
October 13, 2006

The Union of the Comoros, comprising of three small islands, has continuously suffered from weak economic and financial performance. The country has

- inadequate infrastructure,
- high transportation costs,
- a very narrow production base, and
- an underdeveloped financial sector.

The economy has unique characteristics which make it difficult by itself to support the development or the maintenance of critical infrastructure. It is in desperate need of external assistance. Harbors, airports and telecommunications which are vital importance to the economy are inadequate and inefficient, and the economy has relied to a large extent on subsistence agriculture and workers' remittances. Political instability in the recent past has also been a factor. However, the country occupies a pivotal position in the maritime safety and security of the Mozambique channel. All these specificities make the Comoros a case for special assistance from the international community.

After several years of political and social unrests which brought the 3 islands forming the Comoros to the brink of secession, a reconciliation process was started with the help of the international community. In December 2001, the inhabitants of the three islands voted for a new Constitution that keeps the three islands together as an Union, but gave each one more autonomy. Following the approval of the new Constitution, cooperation among the three islands intensified, through the introduction of a consolidated budget, the implementation of a new revenue sharing mechanism and the introduction of regular intergovernmental budget meetings. As agreed, presidential elections, under international supervision, were held in May 2006, and resulted in the overwhelming victory of the new president, Mr. Ahmed Sambi**,** who proceeded quickly to appoint a new government.

The new government attaches the highest priority to improving economic and social conditions as envisioned in the I-PRSP which the government has fully endorsed. It appreciates the support received from the Fund through an intensive policy dialogue and technical assistance, and the SMP.

Under the SMP notable progress has been made in reforming tax and customs policies and consolidating the budget process. Nevertheless, there were slippages in public finances in the pre-election period. As a result the interisland revenue-sharing mechanism broke down; spending increased and salary and external arrears further accumulated.

The new government has moved quickly to correct the situation. Inspection commissions were set up and senior officials, at revenue agencies and public enterprises, suspected of wrong doing have been questioned. A strengthened system of consultation among the islands ministries of finance and the central government have been put in place and all revenues are now channeled through a single account. Transparency and control in revenue administration have improved.

The authorities have also implemented a number of measures to bring the program back on track. A supplementary budget for the Union and the three island governments was approved by parliament in August, and is aimed at bringing public finances back in line with the thrust of the original 2006 budget and SMP objectives. The authorities also strengthened custom administration in the port of Moroni. Expenditures have also been significantly reduced in the second half of the year. In the public enterprise sector, the authorities have replaced senior managers, and taken steps to ensure that the Union and island governments remain current on their utility bills, that rice imports are based on competitive tenders, and that retail prices for rice ad fuel reflect international prices.

My Comorian authorities are confident that these strong measures have laid the foundation for safeguarding the fiscal situation, and will help to bring the program back on track. Preliminary data indicate that the objectives under the revised program are likely to be met.

Moving into a PRGF arrangement is of critical importance to the country's efforts to raise economic growth and improve social conditions. It will enable the country to benefit from external support to implement the development strategy spelled out in its I-PRSP, and obtain debt relief under the HIPC Initiative and the MDRI. Moreover, a PRGF arrangement will help to unblock donor pledges, made at the Donors' Conference held in 2005, and that are linked to a Fund-supported arrangement. My authorities would, therefore, like to request that a Fund mission come as early as possible to Moroni to start discussions on a PRGF arrangement.

Performance in 2005 and 2006, including Under the SMP

An SMP was put in place in February 2005. Its main objectives were to restore the credibility of economic management, improve public finances and accelerate structural reforms. Although not all structural targets were achieved, important progress was made. Real GDP grew by more than 4 percent, in 2005, and real per capita GDP increased by over 2 percent. Inflation was kept under control at about 3.5 percent. Fiscal performance improved as revenue increased and outlays were reduced. As a result, the primary surplus increased, and the government was able to reduce domestic arrears. The terms of trade worsened in 2005 due in large part to low vanilla export prices and higher imports, especially the high oil import bill, although remittances have also been at the base of the increase in import.

However, it should be noted that the large remittances have played a very important role in the economy of the Comoros: they have offset a large trade deficit, contributed to government revenue, provided a buffer against shock, but more importantly has prevented a worsening of poverty.

As noted above, the period leading to the presidential elections caused slippages in the public finances, and disrupted the decentralization system that had been put in place not so long ago. Consequently, interisland tensions over revenue-sharing increased**.** One of the first acts of the new Union Government was to restore cooperation and enhance the decentralization arrangements. It took steps to strengthen the revenue-sharing arrangement and to regain the endorsement of the island governments. All revenues are now channeled into a single special account at the central bank. Daily reports on balances are made available and island representatives have access to central bank information at all times. The new arrangement also stipulates how much is to pay out for salaries thus ensuring that wages are paid regularly.

The new system has improved control over public finances. However, experience has shown that the revenue-sharing mechanism suffers from free rider and moral hazard problems. The system needs to be improved so that there are incentives for each island government to maximize revenue collection and to fully declare those revenues to the central government. The Comoros will require Fund technical assistance in this area so as to make the revenue-sharing system work efficiently.

In the meantime, the Comorian authorities are determined to achieve the specific objectives for the period June – December 2006, which are:

- Restore fiscal revenue collection to the level originally targeted for the second half of 2006, through strengthened tax and customs administrations as well as additional revenue measures.

- Reduce expenditure for the second half of the year. In this regard, several ministries have been consolidated, many high-level advisor positions have been eliminated, foreign official travel has been reduced to the strict minimum, and other discretionary spending is being curtailed.

- Pay down wage arrears accumulated during the first half of the year to keep net domestic arrears accumulation near zero for the year as a whole. In this regard, the authorities are thankful for the grants provided by France, and are looking forward to additional support from the EU.

- Implement a number of structural reforms that were delayed by the election, namely in the area of budge execution, revenue administration, and the preparation of reforms for the telecommunication and hydrocarbons monopolies, and finalizing the draft of the new investment code.

Good progress is being made in all these areas, and many of the measures have already been implemented. My authorities are confident that the objectives under the SMP are being met. Progress has also been achieved as regards discussions on the clearance of external arrears, and efforts are underway to try to find a solution to the arrears to the AfDB.

In spite of low vanilla export price and high energy bill, the external current account deficit has remained relatively low at about 3.5 percent of GDP, mainly due to the large contribution of remittances to the economy. In recent years, remittances have accounted for almost 50 percent of current account receipts, and have allowed for the imports of consumer goods, and provide a buffer against external shocks. In 2004/05, as vanilla prices collapsed, remittances increased and helped to reduce the shock on household income and the balance of payments. Nevertheless, the external position remains fragile, as arrears have accumulated, and external assistance has almost disappeared. At end-2005, the net present value of debt amounted to an estimated 419 percent of exports of goods and services. However, in recent years, the authorities have been able to clear the arrear to the World Bank, but arrears to other creditors have accumulated. Efforts are ongoing to reach agreements with other creditors. In this context, an informal meeting between the authorities and key creditors and donors was held at the IMF during the Spring Meetings this year, and most creditors have since proposed a multiyear rescheduling of arrears. Comoros does not have debt to the IMF.

The Comoros is a member of the franc zone and the Comoros franc is pegged to the euro. This arrangement has served the country well. The authorities view the safeguards under the franc zone arrangement as having provided the country's main anchor of stability and enabled the central bank to follow policies that have helped to keep inflation low. Despite the difficult external position, the Comoros franc is not overvalued.

However, improvement in competitiveness in the Comoros can only be achieved through a tight fiscal policy and comprehensive structural reforms. Dollar wages are in line with comparable countries and are not a factor in the low level of exports. This is due mainly to the narrow export base and structural constraints. The country relies mainly on vanilla for its export earnings. However, with the fall in the world price of vanilla and the increasing competition in this market due to new entrants, Comoros' small production has no influence on vanilla prices. The country also produces small amount of ylang-ylang which is used in perfume production, but earnings are low. The major constraints faced by Comoros regarding exports is the lack of infrastructure, high energy and transport costs, and an underdeveloped financial sector. The limited budget of the Comoros and a lack of donor support have made it impossible for the authorities to deal up to now with these structural constraints, which they intend to address under a PRGF.

Request for PRGF

The Comorian authorities are determined to reverse past trend and address directly the challenges facing the country so as to place the economy on the path of sustainable growth. Capitalizing on the important political changes, the authorities are committed to embark on a comprehensive program of reforms aimed at raising the growth rate, maintained macroeconomic stability, while taking steps to support private sector growth and economic diversification. The strategy the authorities intend to implement has been clearly spelled out in the I-PRSP, prepared with the participation of all main stake holders. The authorities' efforts will focus on improving governance and transparency, strengthening interisland cooperation, reducing poverty, liberalizing trade, reforming public enterprises and creating an environment conducive to the development of a strong private sector.

However, the implementation of such a strategy will require extensive external support. In this context, Fund support under a PRGF arrangement is of critical importance, as it will enable the authorities to obtain additional financial and technical assistance form other donors. At the same time, successful implementation of the PRGF will enable the country to obtain debt relief under the HIPC Initiative and MDRI. The country has been under SMP since 2005 and good progress was made. However, the new authorities have moved quickly to take all needed remedial measures, even ones that were politically difficult. Preliminary indications are that the program is back on track, and my authorities are, therefore, requesting that negotiations on a PRGF arrangement begin as soon as possible. In view of the measures taken and the strong commitment of the authorities to the adjustment process, as well as the efforts to address the external arrears issue, I would appreciate Directors' support to my Comorian authorities' request.