CLASSIFICATION:

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD) SUPPLEMENT

1. PAAD Number: 649-K-606 PDABA256
2. Country: Somalia 64218
3. Category: Foreign Exchange Market Support
4. Date: April 1989
5. To: Lois Richards, Mission Director, USAID/Somalia
6. OYB Change Number: N/A
7. From: Tom Lofgren, S. Project Development Officer, USAID/Somalia
8. OYB Increase: N/A
To be taken from:
9. Approval Requested for Commitment of: $ N/A
10. Appropriation Budget Plan Code: GES7-87-31649-KG31 (770-61-649-00-50-71)
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12. Local Currency Arrangement: ☐ Informal ☒ Formal ☐ None
13. Estimated Delivery Period: April 1989 - Oct. 1989
14. Transaction Eligibility Date:
15. Commodities Financed:

16. Permitted Source	17. Estimated Source
U.S. only	U.S. 15,125,000
Limited F.W.	Industrialized Countries
Free World	Local
Cash 15,125,000	Other Code 935

18. Summary Description

The program purpose is to support an exchange rate system which is substantially market-determined. The program will support the GSDR's overall macroeconomic stabilization, recovery, and structural adjustment program and will provide balance-of-payments (BOP) support to help meet Somalia's critical foreign exchange needs. The disbursement mechanism is a cash transfer. The entire amount of the Grant will be used to finance the payment of part of Somalia's outstanding arrears to the IMF.

The main differences between the original PAAD and this PAAD Supplement are the recognition in the Supplement of the policy reform initiatives made by the GSDR since early 1988, and the manner in which the Mission will disburse the cash transfer to support GSDR implemenation of its structural adjustment program. The original PAAD proposed that $5.0 million of the $15.125 million Grant be used to reduce the public sector's BOP gap in financing multilateral debt payment and major imports, with the remaining $10.125 million being used as BOP support for the now defunct foreign exchange auction system. Since the auction will not be reinstated and since it is the opinion of the Mission, and other donors, including the IMF, that the GSDR has implemented an alternative to the auction worthy of support, this PAAD Supplement allocates the entire $15.125 million to partially meet a critical foreign exchange need, i.e., payment of part of the outstanding arrears to the IMF.

Program conditionality will ensure that A.I.D. funds will be disbursed only if an appropriate exchange rate system, i.e., one that is substantially market-determined, is in place. A covenant will require that the GSDR maintain that system in place for at least one year after the amended program agreement is signed. The conditions precedent and covenants are found on pages 12-13 of this PAAD Supplement.

19. Clearances	Date
PDS:DHimelfarb	4/3/89
PROG:RPeterson	4/3/89
PROG:RMDepp	4/4/89
CONT:MBradley	4/4/89
DD:KRikard	4/8/89

20. Action: ☒ APPROVED ☐ DISAPPROVED

Authorized Signature: Lois Richards Date: April 9, 1989

Title: Mission Director

AID 1120-1 (5-82)

CLASSIFICATION:

FY 87 ESF PAAD Supplement

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I. INTRODUCTION

Somalia has pressing needs for balance-of-payments (BOP) support to pay critical multilateral debt arrears and thus enable Somalia to regain access to IMF resources and to keep its structural adjustment program on track. Given the GSDR's renewed policy reform efforts since early 1988 and, in particular, the noteworthy performance on its economic and financial program initiated with the IMF in July 1988 (including, inter alia, substantial improvement in its exchange rate policy), resumption of ESF assistance suspended when the foreign exchange auction was cancelled in September 1987 is now warranted.

The program described below takes this already improved GSDR policy performance into account and is designed to better reflect the current economic situation in Somalia. The FY 1987 ESF program purpose will remain to support Somalia's efforts to improve its exchange rate policy. Disbursement will recognize policy improvements already made and in place. In addition, the program supports the GSDR's overall macroeconomic stabilization, recovery and structural adjustment program and provides balance-of-payments (BOP) support to help meet a critical foreign exchange need. The disbursement mechanism will be a cash transfer.

The main differences between the original FY 1987 ESF program and this PAAD Supplement are the recognition in the Supplement of policy reform progress made by the GSDR since early 1988, and the manner in which the Mission will disburse the cash transfer to support GSDR implementation of its structural adjustment program and meet its BOP needs. The original program proposed that $5 million of the $15.125 million in FY 1987 ESF be used to help meet the public sector's balance-of-payments gap in financing multilateral debt payment (including commercial bridge loans for multilateral debt) and major imports, and that the remaining $10.125 million be used as BOP support to fund the now defunct foreign exchange auction system. The auction was used to establish and adjust the rate of exchange of the Shilling and to allocate available foreign exchange, mostly provided by other donor CIPs, to those bidding for foreign exchange. Since that auction will not be reinstated, and since it is the opinion of the Mission and other donors, including the IMF, that the GSDR has already implemented an alternative to the auction which has been and remains worthy of support, this PAAD Supplement allocates the entire $15.125 million to meet a critical foreign exchange need, i.e., payment of a portion of outstanding arrears to the IMF. As in the original PAAD, all of the grant funds will provide BOP support.

Timely release of FY 1987 ESF is essential both to recognize Somalia's noteworthy performance since March 1988 on its ambitious reform program, the centerpiece of which has been the new exchange rate system, and to facilitate continuation of reform progress. Disbursement of the U.S. funds dollar will greatly enhance the position of those in the GSDR who are the principal advocates of revitalized economic liberalization initiatives, including further exchange rate adjustment, and who need to demonstrate to key

political leaders tangible benefits resulting from the GSDR's recent economic reform initiatives. The ESF dollar Grant will also contribute toward resolving a serious arrears problem which prohibits the IMF from making Somalia eligible to receive IMF funds and which might adversely affect continued IMF involvement with Somalia on future economic and exchange rate reforms. Without an acceptable IMF program in place, Somalia cannot seek essential debt relief through the Paris Club.

II. BACKGROUND

A. GSDR Policy Reform and ESF Program Prior to 1987

After a decade of Socialism, Somalia embarked on a major effort in the early 1980s to restructure its economy toward a more market-oriented system. Efforts to liberalize the economy included exchange rate reform, elimination of Government control over the marketing of agricultural products, incorporation of private sector participation in the production and export of bananas, and reductions in trade restrictions. In January 1985 a multiple exchange rate system was adopted which included a market-determined rate for most private sector transactions. In September 1986 the GSDR introduced the foreign exchange auction system which provided foreign exchange from the IBRD and bilateral donors for imports. USAID supported the auction in lieu of the previous commodity import programs (CIPs). It contributed $11.011 million in FY 1986 ESF directly to the auction over the February through May 1987 period and planned to contribute another $10.125 million from the FY 1987 ESF grant. In June 1987 the exchange rate regime was unified at the rate determined by an enhanced foreign exchange auction system implemented as part of a new IMF Stand-by Arrangement (S-BA) and Structural Adjustment Facility (SAF).

B. FY 1987 ESF Program Suspension

On September 2, 1987, USAID obligated $15.125 million in FY 1987 ESF to support Somalia's structural adjustment program and to provide balance-of-payments support to help meet Somalia's critical foreign exchange needs. The $15.125 million was to be disbursed in two parts. The first tranche of $5 million was to be disbursed immediately in the form of a cash transfer for use by the GSDR to meet critical public sector needs. It was expected that 60 percent of this tranche would be used to repay a bridge loan from Citibank used to clear IMF arrears so as to enable signing of the new Stand-by in June. The remaining $10.125 million was to be disbursed over a longer period also as a cash transfer and was to be used to fund continued operation of Somalia's enhanced foreign exchange auction system. On September 17, 1987, before any FY 1987 ESF monies had been disbursed, the GSDR abolished its foreign exchange auction system and announced the fixing of the Shilling at a seriously over-valued rate. This contravened a covenant in the Program Grant Agreement. In response, USAID suspended disbursement of the FY 1987 ESF grant. CIPs of other donors which were directly linked to the auction were also put on hold as a result of the GSDR cancellation of the auction.

Immediately USAID and others in the donor community mounted concerted effort to persuade the GSDR to reinstate the auction, or an acceptable alternative, and to resume determining the value ofthe Shilling in a manner more reflective of its actual value. Notwithstanding support from within parts of the GSDR, these efforts were unsuccessful, and on October 11, 1987, the revaluation of the Shilling took effect at a rate of 100 per U.S. Dollar. This represented a 60 percent appreciation in foreign currency terms (38 percent in domestic currency terms) compared to the SoSh 159.9 exchange rate which had resulted from the last foreign exchange auction conducted on September 16, 1987.

In addition to backtracking on the exchange rate policy front, the GSDR reform program stalled in a few other key policy areas as well. No longer subject to the fiscal and monetary discipline required by an IMF Stand-by Arrangement, the GSDR increased government expenditures and permitted large scale expansion of domestic credit. Deterioration in the fiscal and monetary accounts after September 1987 contributed to a major acceleration in price inflation after December 1987. In a futile effort to contain this surge, the GSDR announced price controls on a variety of consumer (only) items, including food, in February 1988. However, enforcement was quite difficult, and the controls did not become operational. No other reforms, e.g. producer pricing, agriculture marketing, were reversed during the period.

C. Period of Intense Policy Dialogue

USAID/Somalia and others in the international donor community continued efforts to convince the GSDR to resume its policy reform program. USAID also brought in a REDSO/ESA Economist to prepare an options paper describing alternative exchange rate regimes in an effort to assist the GSDR in finding a system that would be both economically sound and politically acceptable. The paper was circulated to Party leaders, the pertinent Ministers and Vice Ministers, and members of the GSDR technical committees reviewing policy options.

In December 1987, the U.S. Ambassador to Somalia persuaded President Siad to meet with the IMF Resident Representative. Following this meeting, the IMF Representative agreed to permit an IMF mission to Somalia in March to hold Article IV consultations (generally routine balance-of-payments and macroeconomic policy discussions).

In late December 1987 President Siad reshuffled his cabinet and named the former Minister of Foreign Affairs as the new Minister of Finance and Treasury. In January 1988, the new Minister began a process which contributed substantially toward renewed policy discussions with the IMF and a resumption of GSDR economic reform efforts. The Minister established two GSDR inter-agency committees to review previous GSDR programs with the IMF and to review current economic policy options, including the desirability of establishing a new program with the Fund. The first assessment revealed that the main reasons for falling out of compliance with the previous IMF

program were not disagreement over the objectives of the program but, rather, GSDR difficulties in implementing the program.

There was substantial internal debate within the GSDR regarding exchange rate policy. As the economic situation deteriorated after September 1987 many GSDR officials became convinced that the cancellation of the auction and the revaluation had been a mistake and began to consider various options to reestablish a workable exchange rate system.

D. GSDR Discussions with the IMF

Relations between the IMF and GSDR had been at a low ebb since the cancellation of the foreign exchange auction mechanism; communications between the two were minimal over the October 1987 through February 1988 period. The opportunity to renew policy discussions occurred in March 1988 when the IMF team came to Somalia to hold Article IV consultations as had been agreed with the President. The IMF and GSDR discussed Somalia's economic situation, which had become much more difficult since the cancellation of the foreign exchange auction and partial cutoff of donor (primarily non-project) assistance flows, and the likely content of a credible economic program which would be worthy of IMF support. Further meetings were held in Somalia during May 1988 during which the two significantly narrowed differences on a number of contentious issues and discussed the policy framework which could form the basis for a shadow program with the IMF. In June, the GSDR devalued the Shilling 80 percent in domestic currency terms, paving the way for the next IMF visit in July, this time to negotiate a shadow program. A Letter of Intent was drafted and, on July 24, initialed by both sides. It contained fiscal, monetary, exchange rate and structural adjustment measures which formed the basis of a renewed economic stabilization, recovery and structural adjustment program.

USAID has maintained an active role in facilitating IMF-GSDR negotiations. During the first IMF visit, USAID met with the IMF team to review the economic situation and related political factors and provide substantive suggestions on negotiating with the GSDR. Similar sessions have been held for the successive IMF visits to try to facilitate reaching agreements. USAID has, on at least two occasions, given suggestions of possible compromise solutions to one or the other party on very sticky issues. The Central Bank also found helpful a letter providing USAID comments on various elements of the Policy Framework Paper (PFP) and highlighting relationships between and among the different economic measures. The letter was shared with the IMF, IBRD and other GSDR negotiators.

The interim, six-month program adopted in July 1988 became known as the GSDR's Economic and Financial Program. It included several far reaching and politically difficult measures to be implemented by the GSDR over the July through December 1988 period. These included another major devaluation in August followed by the initiation of an exchange rate adjustment mechanism designed to prevent excessive further over-valuation of the Somali Shilling; expenditure controls combined with tax rate hikes and new taxes aimed at reducing the

size of the fiscal deficit; strict limits on domestic credit expansion in order to prevent excessive pressure on prices and the balance-of-payments; subceilings on net credit expansion to the Somali Government and public enterprises designed to reserve a sufficient portion of available credit for the private sector; a major increase in savings and lending interest rates to help control credit expansion, encourage greater domestic savings, and rationalize lending and investment; measures to open the banking system to domestic and foreign competition and development of plans to abolish state monopolies in several key sectors.

GSDR performance on its economic reform program has been impressive, with many of the reforms completed ahead of schedule, e.g. several fiscal measures were implemented a month ahead of schedule. Just prior to the September 9, 1988 donors' meeting in London, an IMF review of the GSDR economic reform program noted impressive progress. Another IMF review was conducted by a mission to Somalia in late November 1988. The team again gave the GSDR high marks on its performance to date and commenced negotiations with the GSDR on the policy package which would form the basis of a full-fledged shadow program expected to start in 1989. Subsequent to the November discussions, the GSDR has continued to press ahead with its reform efforts by agreeing to permit an independent audit of the Commercial and Savings Bank of Somalia, and in February by passing into law several measures which began the process of dismantling certain state monopolies.

In addition, the IMF/IBRD have negotiated with the GSDR the content of a Policy Framework Paper which outlines the macroeconomic stabilization and structural adjustment measures for 1989-91 to be included in a Stand-by Arrangement and a Structural Adjustment Facility programmed to begin towards the end of 1989. This along with a new Letter of Intent concerning a Shadow Program for CY 1989 were agreed to by the parties in mid-March 1989. Additional information on the status of GSDR policy reform is contained in Annexes 1 and 2.

III. RECENT ECONOMIC PERFORMANCE

A. Overview

Overall economic performance in 1988 was mixed. From the perspective of growth, overall economic trends were not favorable. Real GDP dropped 4 percent, and exports plummeted to less than two-thirds of the level reached in 1987. Regarding internal stabilization objectives, fiscal and monetary trends in 1988 showed marked improvement over 1987. Both government spending and the fiscal deficit shrank significantly in relation to GDP, and, reflecting this improved fiscal performance along with tighter credit controls, growth in the money supply was contained to less than one-half of that recorded in the previous year. Inflation, however, increased nearly three times the 1987 rate to 82 percent for 1988. With respect to stabilization of external accounts, a huge drop in exports was more than offset by sharply falling imports

resulting in a substantially lower trade deficit for the year. External assistance flows slipped to about two-thirds of 1987 levels while external payments arrears surged to new heights.

B. Domestic Output, Investment, Consumption and Employment

The latest estimates for 1988 show that real output fell 3.5 percent. This contrasts sharply with the 9.7 percent real GDP increase recorded in 1987 and the five percent average annual rate of real growth over the 1983 through 1987 period. The 1988 drop reflected major declines in two key sectors which had performed remarkably well since 1984 -- manufacturing and construction. Regarding manufacturing, shortages in essential imported inputs contributed to a 15 percent decline in real output. The manufacturing sector registered an average yearly growth rate of over 7 percent during 1984-1987. Construction declined 18 percent in 1988 following four consecutive years of impressive growth in which the average annual rate of real growth exceeded 9 percent. Also contributing significantly to the reduction in 1988 output was a 10.5 percent decline in GDP in the service sector. Contributing importantly to 1988 declines in manufacturing, commerce and, in particular, construction, were tighter credit policies and government expenditure reductions resulting from the GSDR's strong austerity program initiated in early 1988.

Another important reason for negative overall growth in 1988 relates to less favorable performance in the agricultural sector. Real GDP originating in agriculture grew by only 2.5 percent in 1988 compared to a robust 15 percent achieved in 1987. Nonetheless, given agriculture's disproportionate share of GDP, its moderate growth in 1988 helped offset to a large extent the major declines in other sectors. The big drop in the 1988 agricultural growth rate compared to that in 1987 primarily reflects developments in the livestock subsector which traditionally accounts for over two-thirds of overall agricultural sector output. In 1987 real GDP originating from livestock production increased 20 percent. A major portion of this increase was due to substantial rebuilding of herd sizes in 1987 after a major drought in 1986 severely constrained stock building and contributed to an 11 percent fall in overall livestock production, which, in turn contributed to a 7 percent drop in agricultural output and a 2.1 percent decline in real GDP for the year. In contrast to the exceptionally large increase in 1987, the livestock subsector experienced flat growth in 1988. The 2.5 percent real growth achieved in agriculture during 1988 was almost totally the result of a 10.4 increase in crop production made possible by favorable weather conditions. This was the largest annual increase in that category since 1984-1985 when, spurred by GSDR moves to decontrol agricultural prices and marketing, and also helped by good weather, real annual gains averaged 13 percent.

From a longer perspective, real output in Somalia grew by an average annual rate of only 1.5 percent from 1985 through 1988 and by less than one percent over the 1978 through 1988 period. Given Somalia's estimated population growth rate of somewhere between 2.5 and 3 percent, real per capita income is less today than it was three years ago, and substantially less than it was 10 years ago.

As a percent of GDP, gross domestic investment rose to 35 percent in 1987 compared to 33 percent in 1986. The ratio is estimated to have dropped to 30 percent in 1988. Private fixed investment was equal to only 2.3 percent of GDP in 1988, down from 6.5 percent in 1986 and 5.6 percent in 1987. Real domestic consumption per capita grew 12 percent in 1987 after falling nearly 30 percent from 1983 to 1986, and then dropped an estimated 11 percent in 1988.

While no comprehensive data for overall employment are available, figures on Central Government employment show a 17 percent decrease in 1987 compared to 1986. Although employment opportunities in the public sector have declined in recent years, employment in the private sector is estimated to have increased due to the increased numbers of small, mostly family-owned and operated establishments.

C. Fiscal Performance

The fiscal situation partially improved in 1988. Nominal Government expenditures rose 31 percent, much lower than the 82 percent average rate of inflation for the year and resulting in a substantial decline in real expenditures. As a percent of GDP, total expenditures fell to 24.3 percent. The overall deficit, excluding external donor grants, declined in real terms in 1988 and as a percent of GDP fell nearly one-fourth from its 1987 level to 18.3 percent. On the revenue side, however, the already difficult situation continued to worsen. As a percent of GDP, Government revenues dropped to 5.1 percent, one of the lowest revenue/GDP ratios in the world.

The improved overall fiscal performance in 1988 was needed to reverse the adverse trends of the previous year, in which the fiscal situation showed marked deterioration. As a percent of GDP, the overall fiscal deficit, excluding grants, reached 24.5 percent, up sharply from 16.3 percent in 1986 and almost three times the average for 1980 through 1985 of 8.5 percent. This resulted from a 78 percent surge in Government expenditures in 1987; current outlays grew 49 percent while public investment jumped 116 percent. As a percent of GDP, Government expenditures rose to 30.7 percent in 1987 compared to 24.9 in 1986 and an average of 19.6 percent over the 1980 through 1985 period. Revenue performance was weak. Total Government revenues, excluding grants, equaled only 5.9 percent of GDP, down from 8.1 percent in 1986. In 1983 revenues were equivalent to 11.6 percent of GDP. Financing of the 1987 fiscal deficit required heavy recourse to the domestic banking system as well as substantial external loans and grants.

D. Monetary Developments

Paralleling fiscal developments, monetary trends improved dramatically in 1988 after very weak performance in 1987. In real terms both domestic credit and the money supply declined; nominal increases were 40 percent in domestic credit and 44 percent in the broad money supply, both far below the 82 percent average inflation rate for 1988.

While for 1987 as a whole, monetary performance was highly unsatisfactory, through the first half of the year, monetary indicators were quite favorable. The monetary situation deteriorated sharply after September 1987 when the GSDR abandoned its Stand-By Arrangement with the IMF, cancelled the foreign exchange auction system, boosted Government expenditures and permitted huge excesses in money and credit growth. The broad money supply nearly doubled from June to December 1987, and net domestic credit exploded 153 percent over the same period. Net credit banking system credit to the private sector was permitted to expand three-fold from September to December.

E. Balance-of-Payments and External Debt

Somalia continues to face an increasingly difficult and very severe balance-of-payments situation. In recent years Somalia's exports have been about equal to only one-fourth of the country's imports. In 1988 the ratio was even worse. Export earnings fell to an estimated $60 million, down over 35 percent from levels achieved in 1986 and 1987 when total exports averaged $94 million. This sharp drop was the result of two major factors. First, it reflects the consequences of an over-valued exchange rate since October 1987, which adversely affected the incentive structure for exports, particularly with respect to livestock exports. Second, exports were adversely affected by the outbreak of civil strife in the North in late May 1988 which interrupted the already depressed flows of livestock exports from the region and particularly from Berbera at the time of the peak livestock export season, the Hajj. Foreign exchange earnings from livestock exports plummeted in 1988 to only $22 million, down 64 percent from the $61 million average for 1986 and 1987. On the positive side, earnings from banana exports have grown by over 10 percent over the last two years.

Foreign aid flows fell by about $100 million in 1988 compared to the 1987 levels primarily due to suspension of mainly balance-of-payments assistance in response to the GSDR's abrupt cancellation of the foreign exchange auction system in September 1987. This marked reduction in aid flows, combined with sharply lower export earnings, contributed to a 27 percent drop in imports for 1988 which, in turn, contributed to the estimated 3.5 percent drop in real GDP for 1988.

In addition to its serious external trade problems, Somalia faces a nearly insurmountable external debt burden. Total debt outstanding at the end of 1988 exceeded $2 billion which is almost twice as large as GDP. Scheduled debt service payments in 1988 totalled almost $190 million, nearly three times estimated 1988 exports. By the end of 1988, external debt arrears had accumulated to $267 million. Of this total, $77 million is owed to the IMF and must be cleared prior to any Stand-by Arrangement, Structural Adjustment Facility, or Extended Structural Adjustment Facility with the IMF. An additional $59 million is due to the Fund in 1989.

The Government's need for hard currency to buy arms and other supplies to support its military efforts in the North further contributed to Somalia's foreign exchange squeeze in 1988.

F. Domestic Price Developments

Fueled by excessive monetary expansion during the last half of 1987, price inflation at the consumer level rose to 81.7 percent in 1988, up sharply from the 28.1 percent rate registered in 1987. The average inflation rate over 1985-86 was 37 percent after peaking at 92 percent in 1984. However, monthly inflation rates subsided late in 1988, reflecting the more restrictive fiscal and monetary policies in effect during the last half of the year and seasonally lower food prices. From September to December prices rose at an annual rate of 40 percent. Over the first two months of 1989, inflation edged up again, rising at a 60 percent annual rate primarily due to higher food prices after harvest surpluses were drawn down.

IV. PROSPECTS FOR 1989 AND BEYOND

A. External Obligations

Somalia's scheduled external debt obligations in 1989 total nearly $170 million, substantially more than it is capable of paying. Of this total, about $70 million consist of high priority debt service obligations. These are owed to the IMF, to key multilateral institutions such as the World Bank ($3 million) and the African Development Bank/Fund ($1.7 million), and to the U.S. Government ($10 million in 1989 of which $5.2 million represents PL 480 debt including $1.6 million in 1988 arrears; $4 million is FMS debt including $1 million in 1988 arrears; and $.6 million to AID). Over the 1990 to 1993 period, scheduled debt service averages just under $150 million annually.

B. Exports

With the improved exchange rate policies in place since June 1988, total exports of goods and services in 1989 are projected to reach $78 million, significantly higher than the depressed 1988 level but still much lower than the levels achieved over the 1985-87 period. Gains exceeding 20 percent are anticipated for banana exports, and it is hoped that livestock exports will show a moderate recovery. Overall, other exports are projected to grow by 10 percent in 1989.

C. Growth

Assuming that exports partially recover as expected and that normal assistance flows are restored on a timely basis, real GDP should grow by a robust 7 percent in 1989. While such a jump in real output appears high, it should be noted that it follows on the heels of a sharp drop in real GDP in 1988 and would thus be facilitated largely by activating recently unused capacity. The average annual real rate of growth for the two-year period 1988-1989 is projected at a modest 1.5 percent, substantially below the annual population growth rate.

V. RECENT GSDR POLICY PERFORMANCE

A. Overall Assessment

GSDR performance since March 1988 on its macroeconomic stabilization and structural adjustment program has been good and much better than expected. GSDR progress was favorably reviewed by the IMF and other donors at the September 1988 London donors' conference, and IMF missions to Somalia in late November and March again gave the GSDR high marks. Positive performance was observed in nearly all areas of the program including fiscal, monetary, and exchange rate policies as well as the passage of legislation liberalizing key economic sectors.

B. Exchange Rate Policy

The GSDR's exchange rate policy has improved dramatically since its cancellation of the foreign exchange auction system in September 1987 and the revaluation of the official exchange rate to SoSh 100 per $1.00 one month later. On June 20, 1988, the GSDR devalued the official exchange rate 44 percent in foreign currency terms and 80 percent in domestic currency terms to SoSh 180 per U.S. Dollar. The IMF Letter of Intent, signed on July 24, 1988, committed the GSDR to weekly adjustments of the official exchange rate based on movements in cross rates between the currencies of Somalia's principal trading partners (which make up the basket to which the Somali Shilling is pegged), and on inflation differentials between Somalia and its major trading partners. The first of the weekly official rate adjustments took place on August 7, 1988, when the Somali Shilling was devalued nearly 20 percent in domestic currency terms. Since then, the GSDR has fulfilled its commitment to adjust the official rate each week according to the agreed upon mechanism. At times the required adjustments were quite substantial. For two consecutive weeks in September the weekly devaluations exceeded 4 percent. From the time the GSDR introduced the new system in early August through the the end of December, the cumulative devaluation of the Somali Shilling vis-a-vis the U.S. dollar has been 50.6 percent in domestic currency terms.

The GSDR's positive movement on exchange rate policy has been extended into 1989. In February, in addition to its regular weekly adjustments for inflation, the GSDR made two discrete 5 percent devaluations of the Shilling at the official exchange rate. This was done as part of an overall 25 percent devaluation in domestic currency terms worked out with the IMF earlier in the month to substantially narrow the spread between the official and parallel market rates. Another discrete 5 percent devaluation was made in March. With this last adjustment, the official exchange rate reached 335 Somali Shillings per dollar on March 18. During the period, the free market exchange rate has held steady near 465 Somali Shillings per dollar. Thus, the gap between the official and free market exchange rates has been narrowed to 28 percent of the parallel market rate as compared to 45 percent of the parallel rate as late as November 1988. Further progress toward eventual unification of foreign exchange markets at a realistic exchange rate

is expected as the GSDR continues to negotiate with the IMF and IBRD and proceeds with implementation of its structural adjustment program.

C. Fiscal Measures

The interim program negotiated with the IMF contained measures designed to both control expenditures and to enhance revenues. Specifically, these included the preparation of an action plan to reduce expenditures on foreign representation and to eliminate government subsidies on petroleum products by adjusting retail fuel prices to reflect international petroleum prices and the official exchange rate. Complementing expenditure control measures, the GSDR adopted a number of politically difficult revenue enhancement measures including an increase in the sales tax rate from 5 to 10 percent, the imposition of a 5 percent sales tax on certain services, establishment of an airport departure tax, an increase in the rental income tax rate from 21 to 35 percent, the placing of a 7 percent withholding tax on banana producers, and the replacement of a specific tax with an ad valorem tax on fuel imports -- 40 percent for gasoline and 16 percent for diesel fuel. Based on available estimates for 1988, both current and investment expenditures were below programmed targets.

D. Monetary Program

The six-month interim monetary program adopted last July by the GSDR included bi-monthly ceilings placed on overall net domestic credit expansion with subceilings assigned to net credit expansion to the Central Government, public enterprises and the private sector. Based on available statistics, the GSDR has nearly fully complied with the monetary program limits, the exception being minor excesses in credit to public enterprises.

In addition to credit ceilings, the GSDR raised interest rates with the goal of achieving positive real interest rates by the end of 1988. The Central Bank established a minimum rate of 40 percent for ordinary savings accounts at the Commercial and Savings Bank of Somalia (CSBS). Other savings rates are negotiated between the CSBS and its customers. Further, the Central Bank raised the discount rate to 45 percent and set the minimum lending rate for all credits from the CSBS at 50 percent. Lending rates for loans from the Somali Development Bank were increased by four percentage points. With inflation rates dropping late in the year, lending rates became significantly positive in real terms.

E. Structural Adjustment Measures

The GSDR drafted and obtained legislative approval in February 1989 for a series of new laws aimed at liberalizing key sectors of the economy. Measures passed included opening the banking system to competition from foreign and domestic private banks, and eliminating State monopolies in several key economic sectors, including domestic and export trade in hides and skins, maritime shipping services, insurance, domestic and export trade in frankincense and myrrh, and

the importation and distribution of medicines, medical equipment, and veterinary drugs and equipment. In addition, a classification scheme has been developed and approved by the GSDR Council of Ministers which identifies other specific State enterprises as candidates for divestiture and/or privatization.

F. Other Key Measures

The GSDR has agreed to permit an independent audit of the Commercial and Savings Bank of Somalia which is intended to focus on the Bank's lending practices during the huge surge in credit expansion during the last half of 1987. The final terms and references for the audit are still being negotiated with the IMF and IBRD, but it is to begin in late March 1989. Also, a transparent, nondiscriminatory system for allocating foreign assistance under donor Commodity Import Programs (CIPs) for the private sector was established, and five monthly foreign exchange allocations have been successfully conducted. In addition, the GSDR has resumed some civil service reform efforts. In 1988 the GSDR made a major salary adjustment as called for in the IMF Letter of Intent.

VI. REVISED FY 1987 PROGRAM

A. Program Objectives

The primary objectives of the FY 1987 ESF program remain to support Somalia's structural adjustment program and to provide balance-of-payments support to help meet Somalia's critical foreign exchange needs. In particular, the program will recognize the establishment and maintenance of an appropriate exchange rate policy. The program will provide support critical to keeping the GSDR's overall macroeconomic stabilization, recovery and structural adjustment program on track. This will entail further USAID policy dialogue efforts, appropriately coordinated with the IMF and IBRD, to continue, expand and deepen fiscal, monetary, exchange rate and structural reform measures initiated in 1988. The Mission will support continued GSDR discussions with the IMF toward reaching an agreement on a full-fledged shadow program in 1989. This should lead to a Stand-by Arrangement and a SAF or ESAF in early 1990 which would make Somalia eligible for fresh IMF resources. The Mission will also continue to support further talks with the IBRD toward finalization of the ASAP II agreement which will encourage improved macroeconomic and agricultural sector policies.

B. Program Description

1. Program Purpose

The FY 1987 ESF program purpose remains to provide support for an exchange rate system which is substantially market determined.

In promoting exchange rate policy reform the Mission is directly supporting restoration of a key reform which was earlier set back by

the September 1987 decisions of the GSDR. USAID is also supporting a key component of the GSDR's macroeconomic stabilization, recovery and structural reform program and one of the principal reforms advocated by the IMF, IBRD and bilateral donors. Exchange rate adjustment is required to alter the structure of internal prices such that, by raising the prices of tradeable goods relative to those of non-tradeable goods, a profit incentive is generated to expand production of tradeable goods (including potential new exports and domestically produced substitutes for imports).

In the original FY 1987 ESF PAAD the Mission's objective was to support the GSDR's structural reform program by encouraging the GSDR to maintain an appropriate exchange rate policy. With the foreign exchange auction mechanism in place at that time, the logical means to support sound exchange rate policy was to provide direct cash transfers of foreign exchange to be sold to importers through the auction. Now that that system has been terminated and will not be reinstated, the revised FY 1987 ESF program is designed to support GSDR exchange rate reform being implemented through another appropriate exchange rate regime that is acceptable to the IMF, IBRD and other donors, including the U.S.

2. Conditionality

In the amended FY 1987 program agreement, all conditionality related to the now defunct foreign exchange auction system will be eliminated. To support the establishment and maintenance of a more appropriate exchange rate regime in Somalia, the amended agreement will contain a condition precedent to disbursement that the GSDR will be required to establish an appropriate exchange rate system, i.e. one that is substantially market-determined. In addition, a covenant will be added requiring the GSDR to maintain this exchange rate system in place for a period of at least one year after the date of the amended agreement.

Thus, the specific conditionality of the FY 1987 ESF Program Grant Agreement will be changed by deleting the prior conditionality regarding the auction and requiring:

> "Evidence that an exchange rate system that is substantially market-determined has been established in Somalia".

In addition, a new condition precedent will be included requiring the GSDR to provide:

> "A copy of the Grantee's payment instructions to the U.S. bank and account number designated in Section 2.1(b)."

The new covenant will read as follows:

> "<u>Maintenance of Foreign Exchange Rate System</u>: The Grantee agrees that it will maintain an exchange rate system that is substantially market-determined for a period of not less than one year from the effective date of this amendment."

The revised provision on the local currency Special Account will read as follows:

> The Grantee agrees to establish and maintain a non-commingled Special Account in the Central Bank of Somalia and deposit therein an amount of Somali Shillings equivalent to Fifteen Million One Hundred Twenty-Five Thousand United States Dollars calculated at the highest rate of exchange per U.S. dollar, not unlawful, that is available to anyone in Somalia at the time of the U.S. dollar Grant disbursement. Unless otherwise agreed to in writing by A.I.D., the Grantee shall deposit the total Somali Shillings provided for hereunder into the Special Account established pursuant to Section 2.1(c) of this Agreement within not less than thirty (30) days of the date the U.S. dollar Grant disbursement is made by A.I.D."

C. Attainment of the Proposed Program Objectives

The ESF program supports directly the continuation of the exchange rate system set up under IMF auspices in August 1988, through the use of conditionality and through cash assistance to help Somalia clear its arrears with the IMF. With respect to conditionality, as indicated above, the FY 1987 ESF Program Agreement will contain a Condition Precedent to disbursement requiring the GSDR to establish a substantially market-determined exchange rate system. That system has been in place since August 1988 and continues to function. In addition, the Agreement will include a convenant with which the GSDR agrees to maintain such a system in place for a period of one year from the effective date of the Agreement.

Complementing the conditionality will be the permissible use of the ESF dollar Grant. The program will provide the GSDR with cash resources to be used to pay IMF arrears and thereby enable the GSDR to continue its economic policy dialogue with the IMF and IBRD. Both the IMF and USAID will monitor GSDR performance on its exchange rate policy.

By providing quick disbursing dollar assistance to help Somalia clear its arrears with the IMF, the proposed program will support further GSDR economic reforms, in general, and a more realistic exchange rate policy, in particular. This will occur in two major ways.

First, disbursement of FY 1987 ESF dollars, along with substantial additional assistance from Italy, is needed to help the GSDR reduce its mounting arrears with the IMF. Reduction and eventual elimination of arrears to the IMF is a pre-condition to first, a full Shadow Program, and second, a Stand-by Arrangement and Structural Adjustment Facility which would provide Somalia access to additional IMF resources. A portion of the new IMF funds available

under a S-BA, SAF or ESAF would most likely be needed to pay back bridge loans obtained to complete payment of all arrears to the Fund. Having a Stand-By in place is a pre-condition for further debt relief from the Paris Club. Moreover, timely payment of arrears to the Fund, even if only partial, may be necessary to keep the Fund engaged in Somalia's economic reform process.

Secondly, the dollar disbursement will greatly enhance the position of those in the GSDR who are the key advocates of further economic liberalization measures, including exchange rate adjustment, who need to demonstrate tangible benefits resulting from the program to both their adversaries and supporters. Continued suspension of FY 1987 ESF could be misinterpreted by the GSDR as lack of U.S. support for Somalia.

D. Existing Exchange Rate System

The current exchange rate system in Somalia consists primarily of three separate foreign exchange markets -- the official market, the free foreign exchange market, and foreign exchange made available to importers through donor CIPs. In the latter two markets, while segmented, the exchange rates are determined by market forces. In the official market, while the exchange rate is fixed, the GSDR has developed a mechanism to adjust it weekly in conformance with its agreement with the IMF.

1. The Official Market

The official foreign exchange market includes, primarily, Central Government and other public sector transactions. It is supplied by the 60 percent of export proceeds which must be surrendered to the Central Bank by foreign embassies' and donors' purchases of domestic currencies to finance local operations, and direct cash assistance to the GSDR. While fully reliable statistics are not available, the transactions in this market account for the largest share of all foreign exchange transactions, i.e. approximately 30-50 percent of total exports and imports (excluding project related assistance).

The official exchange rate is pegged to a basket of currencies of Somalia's principal trading partners. It is adjusted weekly based on changes in cross rates of the currencies in the basket and the inflation differentials between Somalia and its main trading partners. In addition to the weekly adjustments described above, the GSDR has made several discrete devaluations since June 1988 to further narrow the gap between the official and free market exchange rates. Although this mechanism does not produce a true market-determined official exchange rate, it is designed to prevent excessive further over-valuation of the official exchange rate and to adjust the official rate in a manner which will bring it much closer to what a true market rate would be. Further adjustments to the official rate are expected as the GSDR continues to negotiate with the IMF and IBRD and proceeds with implementation of its structural adjustment program. Eventually the official and other

exchange rates should be unified. Notably, the inflation-adjusted basket of currencies mechanism now in place follows closely the proposal for an exchange rate mechanism originally suggested by the IMF before it was agreed to implement the auction system used in 1986-87.

2. The Free Foreign Exchange Market

This market consists primarily of private sector transactions. The exchange rate in this market is determined by the forces of supply and demand. It is supplied by the 40 percent of export earnings which exporters are permitted to retain in foreign currency denominated accounts at the Commercial and Savings Bank and by foreign remittances; exporters either sell foreign exchange to importers in this market or use it themselves to finance imports. Virtually all private sector cash imports not obtained through CIPs are financed through this market. Transactions in this market represent about 30-50 percent of total non-project trade.

3. Coordinated CIP Foreign Exchange Mechanism

As part of its interim economic program developed with the IMF, in November 1988 the GSDR commenced a transparent and competitive system to allocate foreign exchange made available through donor CIPs to eligible importers. The system was designed by the IMF and IBRD and results in an effective exchange rate which is partially determined by market forces. The Central Bank announces the amount of foreign exchange available for allocation each month (to date between $4.0 million and $5.0 million each month) and the types of imports eligible. Importers requesting foreign exchange must pay a non-refundable levy in domestic currency equivalent to 10 percent of the amount of foreign exchange requested based on the official exchange rate. In addition, the importers must make an up-front deposit in local currency equivalent to 50 percent of the foreign exchange requested, again based on the official exchange rate. If the total amount of all approved requests does not exceed the amount available for the monthly allocation, then each importer is allocated the amount requested. Should the total amount requested exceed the amount available, the available foreign exchange is distributed among all eligible importers on a pro rata basis. Once the requests are approved, importers must deposit an amount in local currency equal to the foreign exchange authorized less the deposit already made. Thus the importer must deposit the local currency equivalent of 100 percent of the import value before opening a letter of credit. Under normal circumstances only a 50 percent deposit is required, with the balance due upon delivery of the goods. Therefore, importers must forego the interest which would have accrued on the extra 50 percent required to be deposited under the program. With interest rates for savings accounts currently at 40 percent, and given the usually long time required to import under CIPs, the amount of foregone interest results in a significant additional cost to the importer. This added cost, combined with the 10 percent levy, results in an effective exchange rate for the program significantly depreciated from the official rate.

In instances where the amount of foreign exchange requested exceeds the amount available, since the initial levy is fixed as 10 percent of the amount requested, the effective levy on the amount authorized for each importer rises above 10 percent. As additional demand pushes the total amount of foreign exchange requested progressively higher than the amount available for each allocation, the effective levy increases and thus the effective exchange rate (in Shillings per Dollar) depreciates further. Thus the effective exchange rate for this segment of the foreign exchange market responds directly to market forces, albeit segmented ones. Transactions in this market represent about 20-30 percent of total non-project trade.

4. Assessment of Existing Exchange Rate System

While the ultimate goal of a completely unified FX regime at a fully market-determined exchange rate has not yet been attained, the system in place is substantially market-determined and worthy of support. The GSDR has improved its exchange rate policy dramatically since September-October 1987. The current exchange rate system is functioning properly, is flexible, corrects the problems which led to Mission suspension of the FY 1987 program in September 1987, and is acceptable per the U.S. position taken at the September 9, 1988 donors' conference in London. The current exchange rate system also permits the repatriation and sale of foreign exchange at a market-determined exchange rate in the free foreign exchange market. Further, 40 percent of export earnings are permitted to be sold by exporters in the free foreign exchange market. Moreover, as part of its program with the IMF and IBRD, the GSDR has successfully implemented an open and transparent system for allocating foreign exchange provided through donor commodity import programs to importers at an effective exchange rate that responds to market forces.

E. Use of ESF for Debt Payment

The GSDR has made remarkable progress in the implementation of its economic and financial program developed with Fund assistance in July 1988. In order to become eligible for a full-fledged IMF Shadow Program, the GSDR must become current with debt owed the Fund during CY 1989. This will require payments of about $28 million during the first six months and of $27 million during the last half of 1989. Moreover, prior to initiation of an IMF Stand-by Arrangement and SAF or ESAF, Somalia must clear $77 million in arrears to the Fund which accummulated over the mid-1987 through 1988 period. In sum, about $130 million will be needed by the end of 1989 to bring Somalia completely current with its IMF obligations.

Somalia does not have the foreign exchange resources to pay its IMF arrears. Somalia's total debt outstanding at the end of 1988 exceeded $2 billion, and scheduled debt service payments in 1988 approached $200 million. Somalia's export earnings for 1988 are estimated to be only $60 million, and, assuming a moderate recovery, exports in 1989 could conceivably reach about $78 million. Moreover, as of the end of 1988, external debt arrears, including the $77 million owed to the Fund, had accumulated to $267 million.

At the London donors' conference on Somalia's economic reform and debt situation last September, the donors agreed that additional fuel or cash assistance from donors would be necessary to help Somalia close its cash gap for 1988 and 1989. The USG and Italy are the only donors so far able to provide cash assistance.

The achievement of an IMF Stand-by Arrangement and a SAF/ESAF would provide fresh resources to Somalia over the medium term, resulting in an improved debt portfolio for the GSDR. The IMF loans associated with the new programs would be made on a highly concessional basis, i.e., the grant element of the new loans would be quite high.

F. Eligible Categories for Debt Payment

It is intended that the entire $15.125 million in FY 1987 ESF be used for GSDR debt to the IMF as agreed to by USAID, State and Congress. To allow for some flexibility should conditions so justify, the FY 1987 ESF Program Agreement will state the following: "The dollar Grant made available under Section 3.1 for Grantee needs may be used only to pay IMF arrears of the Grantee except as A.I.D. may otherwise agree in writing."

VII. ADMINISTRATIVE PROCEDURES

A. Responsibilities of USAID

USAID will regularly monitor all aspects of the GSDR's balance-of payments and exchange rate systems. The Mission will particularly be engaged in dialogue with the GSDR to track continued implementation of exchange rate reform.

USAID will verify that appropriate GSDR payment instructions are in place prior to the disbursement of funds to assure that dollar funds are disbursed to the IMF after being deposited into the Special Account. USAID will also verify that funds are not commingled with those of the GSDR or any other donor, and that the required amount of local currency is deposited into the Special Account (see Section E.2., below). USAID will jointly program the uses of local currency to assure that it is used for financing mutually agreed upon activities such as those contained in the GSDR Public Investment Program (PIP) and local costs of USAID projects. Debt repayment is a further permitted use of the local currency.

The procedures for programming and disbursing funds have been improved upon since the original PAAD was prepared. Such improvements include a reduction in the number of projects financed, increased consultation with other donors regarding their support of projects included in the PIP, more careful preparations of budgets, a new requirement to prepare implementation reports prior to release of budget tranches, and greater awareness of A.I.D. project officers regarding their responsibilities to monitor local currency uses at the project level.

B. Responsibilities of GSDR

The overall administrative responsibility for the Grant will rest with the Ministry of Finance and Treasury (MOFT). This Ministry, together with the Central Bank, will be responsible for ensuring that both dollar Grant funds and local currency deposited by the GSDR into a Special Account (equivalent to the full amount of the dollar Grant) are expended only for eligible uses under this program. The MOFT will provide USAID with necessary documentation regarding use of the dollar and local currency funds. Regarding the dollar Grant, this will include a copy of the payment instructions to the U.S. bank prior to the disbursement by A.I.D. of the dollar Grant into the U.S. bank account. It will also include documentation from the U.S. bank that the dollar Grant was disbursed for the required purpose. Regarding local currency, the MOFT has responsibility for preparing the annual local currency budget and for the management of the receiving and disbursing accounts, which includes financial controls and disbursment. The Ministry of National Planning and Juba Valley Development manages the PIP and has responsibility for its monitoring and evaluation of local currency-financed activities. MOFT will have responsibility for fulfilling the local currency utilization reporting requirements of A.I.D.

C. Disbursement Schedule

It is expected that the full Grant amount of $15.125 million will be disbursed approximately one month from the signing of the Program Grant Agreement Amendment. Only one disbursement for the full amount of the Grant is anticipated.

D. Records and Auditing Rights: (no change from original PAAD)

E. Program Resources

1. Foreign Exchange

The original PAAD proposed that $5.0 million of the $15.125 million in FY 87 ESF be used to help meet the public sector's balance-of-payments gap in financing multilateral payments and major imports, and the remaining $10.125 million be used to fund the now defunct foreign exchange auction system. This PAAD Supplement allocates the entire $15.125 million for financing multilateral debt payments, specifically to pay IMF arrears, and thereby, enables the GSDR to continue its economic reform program with the IMF and to keep the IMF on the scene to monitor implementation of the foreign exchange rate adjustment mechanism.

2. Local Currency

As in the original PAAD, the modified program in this PAAD Supplement will result in a GSDR deposit of local currency equivalent to the full amount of the Grant. Local currency will be deposited into a Special Account at the highest rate per U.S.

dollar, not unlawful, that is available to anyone in Somalia at the time of the U.S. dollar disbursement. Local currency for the full amount of the Grant will be deposited into a Special Account within thirty (30) days of the date the U.S. dollar disbursement is made.

As in the original PAAD, this Supplement maintains the provision that ten percent of the local currency generated under the Grant will be set aside for administrative support of the A.I.D. Assistance Program in Somalia. The remainder (90%) will be jointly programmed by USAID and the GSDR for critical development priorities, including the local currency costs of mutually agreed upon development activities and the purchase by the GSDR of foreign exchange for debt repayment.

VIII. U.S. SPECIAL INTERESTS (No change from original PAAD)

ANNEX 1. SUMMARY STATUS OF GSDR COMPLIANCE WITH JULY 24, 1988 IMF LETTER OF INTENT

Policy Area		Proposed action	Timing	Implementation
Fiscal Policy				
(1)	Counterpart funds	All counterpart funds held with the Commercial Bank will be transferred to the Central Bank.	By end 1988.	Fully implemented.
(ii)	Distribution of social and productive expenditures and salaries in current budget	The Government will review the distribution and salary levels.	No commitment on timing.	In process.
(iii)	Government recurrent expenditures	Seek World Bank assistance to review public expenditures and recommend restructuring.	1989.	
(iv)	Expendure on foreign representation	Prepare action plan to reduce expenditures by one quarter in foreign exchange in 1989.	By end October 1988.	Initiated. Staffs reduced.
(v)	Fuel import tax	Replace specific tax on imports by ad valorem tax, namely 16 percent for diesel fuel and 40 percent for gasoline.	No later than September 15, 1988.	Fully implemented prior to September 15, 1988.
(vi)	Sales tax	Increase ad valorem sales tax rate form 5 to 10 percent.	No later than September 15, 1988.	Fully implemented August 1, 1988.
(vii)	Tax rate on rental income	Increase rental income tax rate from 21 to 35 percent.	No later than September 15, 1988.	Fully implemented August 15, 1988.
(viii)	Tax on gross income of banana producers	Withholding tax of 7 percent on gross income of banana producers will be credited towards income tax obligations.	No later than September 15, 1988.	Fully implemented August 1, 1988.

Policy area		Proposed action	Timing	Implementatation
(ix)	Coverage of service tax	Extend service tax of 5 percent to almost all service activities including travel agents, airlines, restaurants, etc.	No later than September 15, 1988.	Partially implemented August 3, 1988.
(x)	Airport tax	Impose airport tax of US$20 for nonresidents, and the equivalent in shillings for residents.	No later than September 15, 1988.	Partially implemented August 3, 1988. Residents to pay only 1000 SoSh.
(xi)	Restructuring of public enterprises	Propose an action plan for liquidation of uneconomic public enterprises. Idenfify public enterprises to be privatized and those requiring rehabilitation. Prepare timetable for privatization and review with World Bank.	By end December 1988.	Classification scheme developed.
(xii)	Public enterprise pricing policies	Public sector enterprises will be allowed to pass on full impact of exchange rate adjustments in price setting.	Continuous.	
(xiii)	Retail prices of petroleum products	Keep retail prices of petroleum products adjusted to reflect international prices and exchange rates.	Continuous.	Fully implemented. Adjustments made in September and November.

Policy area		Proposed action	Timing	Implementation
Monetary Policy				
(i)	Structure of interest rates	Central Bank will establish minimum lending rate of 40 percent for ordinary savings leaving Commercial Bank and customers to negotiate all other rates.	By August 1, 1988.	Fully implemented.
		Central Bank will raise discount rate to 45 percent	By August 1, 1988.	Fully implemented.
		Minimum lending rates for all credits to be 50 percent.	By August 1, 1988.	Fully implemented.
		All lending rates for Somali Development Bank to be increased by 4 percentage points.	By August 1, 1988.	Fully Implemented
		Central Bank will review all base rates.	At least monthly.	Fully implemented.
		Establish positive real deposit rates.	By end 1988.	Achieved in December.
(ii)	Total domestic credit	Not to exceed:		Actual Amount:
		So.Sh. 42.9 billion	End August 1988	SoSh 41.7 billion
		So.Sh. 47.6 billion	End October 1988	N.A.
		So.Sh. 48.5 billion	End December 1988	SoSh 48.3 billion[1]
(iii)	Total net credit to Government	Not to exceed:		Actual Amount:
		SoSh 18.0 billion	End August 1989	SoSh 16.2 billion
		SoSh 21.5 billion	End October 1988	N.A.
		SoSh 21.2 billion	End December 1988	SoSh 20.4 billion[1]
		If additional counterpart funds above SoSh 11.2 billion are forthcoming, then ceilings reduced pari passu.		

[1] Latest available IMF estimate.

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Policy area		Proposed action	Timing	Implementation
(iv)	Total net credit to public entities	Not to exceed: SoSh 9.8 billion SoSh 10.1 billion SoSh 10.3 billion	 End August 1988 End October 1988 End December 1988	Actual Amount: SoSh 10.3 billion N.A. SoSh 11.5 billion[1/]
(v)	Auditing	Commercial Bank accounts will be audited by an internationally recognized accounting firm.	Accounts for 1987 will be audited by March 1989 and those for 1988 by December 1989.	Auditors appointed. Audit to begin April/May 1989.
Exchange rate regime				
(i)	Export incentives	Exporters to surrender 60 percent of earnings at official exchange rate, the remaining 40 percent can be retained by exporters to be credited to their export/import accounts in the Commercial Bank. Balance in export/import accounts and external accounts may be freely traded.	At time Goverment of Somalia agrees to program.	Fully implemented August 7, 1988.
(ii)	Exchange rate level	Official exchange rate (announced at SoSh 180=US$1 on June 20) to be adjusted regularly starting June 1 using basket of currencies of Somalia's principal trading parnters to reflect differential inflation rates.	Not less than once per week.	Fully implemented.
		Adjustment between June 1 and July 31 to be completed.	Starting immediately. Completion no later than August 15, 1988.	Rate adjusted accordingly on August 6, 1988 to SoSh 215=US$1, and on August 13 to SoSh 225=US$1.

1/ Latest available IMF estimate.

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Policy area		Proposed action	Timing	Implementation
		The gap between the official and market exchange rates will be reviewed with the IMF in light of balance of payments developments and the need to increase external competitiveness.	By October 1988.	Fully implemented.
(iii)	Commdity import programs	Foreign exchange under these programs will be allocated to importers who request funds, and pay a 10 percent non-refundable fee, according to the proportion of funds in demand and the total funds available for each month.	Following start of program and agreement with donors	Fully implemented August 7, 1988.
Balance of payments and debt				
(i)	Purchase of Airbus	The Government will cancel contract to purchase the Airbus and advise IMF of terms and conditions under which contract has been cancelled.	Before September 15, 1988.	IMF dropped requirement.
(ii)	Debt service	The Government will ensure that forthcoming debt service obligations to the IMF, the World Bank and the African Development Bank are met and overdue obligations to the Fund at end-December 1988 will not exceed end-June 1988 level.	From September 15, 1988.	GSDR is current with World Bank, ADB; but not with IMF.

Policy area		Proposed action	Timing	Implementation
Structural adjustment				
(i)	Banking syster	The Government will introduce legislation to open the banking system to provide local and foreign banks and financial institutions to operate in Somalia.	By end December 1988	Decree law published in the Official Bulletin. Enabling regulations being drafted.
(ii)	Frankincense and myrrh	The government will abolish the state monopoly on domestic marketing and exports of frankincense and myrrh.	By end December 1988.	Decree law published in the Official Bulletin. Enabling regulations being drafted.
(iii)	Trade in veterinary drugs	The Government will abolish the authority of state the monopoly on the import and distribution of veterinary drugs.	By end December 1988.	Decree law published in the Official Bulletin. Enabling regulations being drafted.
(iv)	Land tenure	The Government will seek the World Bank's assistance to develop an action plan to improve land tenure policy and administration.	During 1988 to be implemented in 1989.	Fully implemented.
(v)	Hides and skins	The Government will reach understandings with the World Bank on a timetable for the liberalization of the domestic and export trade in processed and unprocessed hides and skins.	By end December 1988 to be implemented in 1989.	Decree law published in the Official Bulletin. Enabling regulations being drafted.

Policy area		Proposed action	Timing	Implementation
(vi)	Maritime shipping services	The Government will reach understandings with the World Bank on abolishing the state monopoly on maritime shipping sevices.	By end December 1988 to be implemented in 1989.	Decree law published in the Official Bulletin. Enabling regulations being drafted.
(vii)	Insurance	The Government will reach understandings with the World Bank on abolishing the state insurance monopoly.	By end December 1988 to be implemented in 1989.	Decree law published in the Official Bulletin. Enabling regulations being drafted.

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ANNEX 2

LEGISLATION PASSED BY PEOPLE'S ASSEMBLY TO LIBERALIZE ECONOMY

Prior to its adjournment in mid-January, the Somali People's Assembly openly discussed, debated and passed seven pieces of new legislation aimed at liberalizing key sectors of the economy. Measures passed included opening the banking system to competition from foreign and domestic private banks and the elimination of state monopolies in the following areas: domestic and export trade in hides and skins, maritime shipping services, insurance, domestic and export trade in frankincense and myrrh, and the importation and distribution of medicines, medical equipment, and veterinary drugs and equipment. Draft legislation was prepared by the Ministry of Finance and Treasury and submitted, first to the Council of Ministers, and then to the Somali Revolutionary Socialist Party Central Committee for discussion and debate. All seven draft laws were approved by the Council of Ministers and by the Party Central Committee prior to consideration by the People's Assembly. Once signed by the president and published in the official bulletin, these laws will become effective. The following describes the essential components of each of the new laws passed by the People's Assembly.

Establishment of Private Banks

This legislation permits the establishment of private banks in Somalia. Private banks have been forbidden since 1970 when all banks were nationalized. Requests to establish a private bank must be approved by the Ministry of Finance after considering the recommendation of the Governor of the Central Bank. The Central Bank will be responsible for supervising the operations of the private banks in accordance with Somali banking laws in effect prior to 1970. The Central Bank is currently reviewing such laws. The initial legislation passed by the People's assembly called for final approval of requests to establish private banks to be made by the Council of Ministers, after considering the recommendations of the Ministry of Finance. This was considered to be too political by a number of GSDR officials and a subsequent amendment was made to require only Ministry of Finance approval, as above.

Liberalization of Hides and Skins Industry

This legislation permits the private sector to engage in domestic and export trade in both processed and unprocessed hides and skins. Trade in this industry will be subject to directives to be issued by the Ministry of Commerce and Industry. The GSDR parastatal, the hides and skins agency, will be permitted to compete with private sector firms for the time being. The original legislation proposed by the Ministry of Finance and approved by the Central Committee

called for the liberalization of processed hides and skins only, leaving the much larger and more lucrative segment of unprocessed hides and skins under the control of the state monopoly. Reportedly, during open discussion on the measure in the People's Assembly, one member of the Assembly moved for full liberalization of the industry. The question was debated immediately and reportedly supported by the Minister of Finance who was present for the debate. The draft legislation was amended on the spot to extend full liberalization to unprocessed hides and skins and was approved.

Private Insurance Establishment Law

This legislation permits the establishment of private insurance companies in Somalia. Previously only the Government owned and controlled State Insurance Company of Somalia (SICOS) was permitted to operate. Requests for the establishment of private insurance companies must be approved by the Ministry of Finance and Treasury. SICOS will be permitted to compete with private sector insurance companies.

Liberalization of Frankincense and Myrrh

The private sector is permitted by this law to engage in both domestic and export trade in frankincense and myrrh. Such trade will be governed by directives to be prepared by the Ministry of Industry and Commerce. Existing government parastatals will be permitted for the time being to compete with private sector firms in this sector.

Veterinary Medicines and Equipment Law

This law permits the private sector to engage in the importation and distribution of veterinary drugs and equipment. The Ministry of Livestock, Foresty and Range will be permitted to compete with private sector firms. Private sector entities requesting permission to trade in veterinary supplies must obtain the proper import license and have access to appropriate storage facilities. It is required that all veterinary medicines be acquired from reputable companies that are properly registered by their respective governments. The Ministry of Livestock, Forestry and Range will issue directives to govern trade in veterinary drugs and equipment and will establish a Registration and Supervision Committee (RSC). All private sector entities seeking authorization to import and distribute veterinary supplies must register with the RSC and will have to pay a 10,000 shilling (about dols 36 at the official exchange rate) registration fee.

Private Shipping Services

Private maritime transport and shipping businesses may now be established in Somalia. The Ministry of Fisheries and Ports will

have the supervisory authority for all private shipping services and will issue implementing regulations. Existing government shipping agencies will be permitted to compete with private entities.

Liberalization of Medicine and Medical Equipment

The new legislation permits private sector entities to engage in the importation of (human) medicines and medical equipment. The Ministry of Health will issue implementing regulations and all private sector entities seeking eligibility must be registered by the Ministry of Health. Existing government agencies involved with the importation of medical supplies will be permitted to compete with the private sector.

CONSTITUTIONAL CHANGES MADE TO REFLECT NEW ECONOMIC ORIENTATION

In order that the Somali constitution more accurately reflect the new economic direction signaled by the passage of this legislation, the People's Assembly also approved several constitutional amendments. Despite significant opposition and heated discussion in the People's Assembly, a number of articles were successfully amended as proposed by the GSDR executive branch and Party Central Committee. While the text of the approved constitutional amendments is not yet available, the articles successfully changed during the People's Assembly session included most of those in Chapter III, Section 1 which pertain to the economy. GSDR sources indicate that essentially these articles were redrafted to elevate the importance of the private sector and to limit the role of the state.