CLASSIFICATION: PD BBI 294

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

1. PAAD Number: 649-0139 649-K-606

2. Country: Somalia

3. Category: Foreign Exchange Market Support II

4. Date: July 20, 1987

5. To: A-AA/AFR, Walter Bollinger

6. OYB Change Number:

7. From: AFR/PD, Carol Peasley C. Peasley

8. OYB Increase: $15,125,000
To be taken from: ESF

9. Approval Requested for Commitment of $15,125,000

10. Appropriation Budget Plan Code: GES7-87-31649-KG31 (770-61-649-00-50-71)

11. Type Funding: ☐ Loan ☒ Grant

12. Local Currency Arrangement: ☐ Informal ☒ Formal ☐ None

13. Estimated Delivery Period: July 1987 - July 1988

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 Somalia's structural adjustment program for exchange rate unification through an auction system. The program mechanism is cash transfer. A share of program funds will help meet the public sector's balance of payments gap in financing external multilateral debt payment and major imports. Remaining program funds will support Somali private sector imports from Code 935 countries through a foreign exchange auction system. To satisfy the financial tracking requirements of the FY 87 Continuing Resolution, A.I.D. funds for the auction will be disbursed into a special U.S. Bank account. This bank will report to A.I.D. on all letters of credit paid with funds from this special account. The World Bank procurement unit in Mogadishu, Somalia, will screen all letters of credit for conformance with the Code 935 source/origin requirement. A.I.D. funds for the public sector will be disbursed into another special account, with separate bank statements provided on final uses. If public sector cash is used for imports, Code 935 source/origin requirements will apply.

Program conditionality will ensure that A.I.D. funds for the auction will only be disbursed if an acceptable auction mechanism is established and maintained through final date of A.I.D.'s disbursements. Further, a covenant in the grant agreement will provide for GSDR collaboration with A.I.D. on policy dialogue and studies needed for the definition of a three-to-five year plan for budget rationalization, tax revenue enhancement and civil service reform.

The conditions precedent and covenants are contained on page 75 of this PAAD.

19. Clearances

Clearance	Date
AFR/DP, JPatterson JGovan for	7-27-87
GC/AFR, MAKleinjan MAK	7/24/87
AFR/EA, SMintz DM for	7/27/87
M/FM, EOwens	7/28/87
AFR/PD, JGraham	7/24/87
for AFR/CONT, RKing CRK	7/27/87
DAA/AFR/ESA, ELSaiers	8/1/87

20. Action

☑ APPROVED ☐ DISAPPROVED

Authorized Signature

Date 8/6/87

Title (Acting) Assistant Administrator, Bureau for Africa

AID 1120-1 (5-82)

CLASSIFICATION:

PROJECT ASSISTANCE APPROVAL DOCUMANT

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GRAPHS

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON D C 20523

ACTION MEMORANDUM FOR THE ACTING ASSISTANT ADMINISTRATOR FOR AFRICA

FROM: AFR/PD, Carol Peasley C. Peasley

SUBJECT: Somalia - Foreign Exchange Market Support II (649-0139) Project Assistance Approval Document

Action Requested: Your approval is requested for a cash transfer of $15,125,000 to the Government of the Somali Democratic Republic (GSDR) from the FY 1987 Economic Support Fund appropriation.

Background: Somalia is one of the poorest countries in the world, with a per capita income of approximately $260 per year. The country entered 1987 with an external debt of $1.9 billion. External debt exceeds GDP, and unrescheduled debt payments exceed export earnings. Furthermore, the value of the country's imports are generally three to four times as great as export earnings (primarily receipts from livestock).

After, a decade of socialism, the GSDR entered the 1980's with little private sector capability. Since that time, the GSDR has eliminated price restrictions on almost all producer and consumer goods, and abolished most import/export restrictions. In 1985, the country opened a free foreign exchange market for legal one-on-one sales by the private sector (and occasionally for GSDR purchase of foreign exchange). Previously, most foreign currency was allocated by the Government, not by a market-determined mechanism, and was sold at a fixed, over-valued exchange rate, though imports could be financed with an individual's own foreign exchange. Currently, the GSDR still maintains an over-valued official rate for the majority of its own transactions.

An extension to the 1985 IMF Agreement, signed in April 1986, provides for unification of the official and free market exchange rates. A.I.D. supports establishment of a unified market-determined exchange rate through an auction system to send correct signals to importers and exporters and to expand the share of Somalia's scarce foreign exchange which will be allocated by an economically efficient mechanism.

The FY 86 program provided $11 million for a donor auction of foreign exchange for imports. The auction was well run and, after a start-up period, sold foreign exchange at a rate close to the free market rate.

Program Description: The program purpose is to support Somalia's structural adjustment program for foreign exchange rate unification through an auction mechanism.

Under this program, A.I.D. will provide the GSDR with a share of program funds (currently proposed to be $5 million) for priority public sector needs. Allowable expenditures would include external multilateral debt repayments (including payment to commercial banks of bridge loans for multilateral debt payment), and major imports. Because of the seasonal nature of livestock export earnings, which become available in late summer, the public sector share of A.I.D.'s program funds will be sufficient to enable the GSDR to begin the proposed new IMF reform program. The ECPR decided to allow the GSDR discretion regarding allocation of funds to the highest priority uses among multilateral debt repayment, commercial bridge loans for multilateral debt payment, and/or major imports. The GSDR will most likely use A.I.D.'s cash to repay Citibank for a bridge loan previously contracted to pay IMF arrears.

The remainder of program funds (approximately $10.5 million) will be sold to the private sector through an expanded auction system for importation of commodities. Under the new IMF program, all private sector export proceeds will be sold to the GSDR at the auction rate, and the GSDR will place up to fifty percent of these export proceeds into an expanded foreign exchange auction system. Funding provided by A.I.D. for public sector needs releases GSDR export proceeds for the auction. The ECPR decided to limit U.S. funds for the auction to Code 935 countries, to respect historical trade patterns experienced under past CIP's, e.g. imports from Saudi Arabia and other Gulf states. To the extent that A.I.D. funds are used for public sector procurement, the same Code 935 source/origin restrictions will apply.

Based on the FY 87 Continuing Resolution provisions, the cash transfer will be traceable to its final use, with information provided on countries of source/origin and type of commodity, for any imports purchased with A.I.D. auction funds. Consequently, A.I.D. funds for the auctions will be disbursed into a special account and will not be commingled with those of the GSDR or any other donor. The IBRD procurement unit in Mogadishu will review letters of credit submitted by auction bidders, and will forward them to a U.S. commercial bank for payment. The commercial bank confirming letters of credit for payment will keep separate records on uses of A.I.D. funds from the special auction account. The public sector share of A.I.D. funds will be disbursed into another special account, and a provision in the grant agreement will require bank account reports on final uses of these funds as well.

Program conditionality will ensure that A.I.D. funds for the auction will only be disbursed if an acceptable auction mechanism is established and maintained through final date of A.I.D.'s disbursements. Further, a covenant in the grant agreement will provide for GSDR collaboration with A.I.D. on policy dialogue and studies needed for the definition of a three-to-five year plan for budget rationalization, tax revenue enhancement and civil service reform.

A categorical exclusion from environmental assessment was approved on July 23, 1987. A Congressional Notification was submitted to the Hill on July 6, 1987, and the waiting period expired without objection on July 20, 1987.

Recommendation: It is recommended that you approve the attached Program Assistance Approval Document by signing the PAAD Facesheet.

Approved [signature]

Disapproved ____________

Date AUG 6 1987

Clearances:

AFR/DP:JPatterson	[initials]	Date	7/27/87
GC/AFR:MAKleinjan	(draft)	Date	7/24/87
PPC/EA:KKauffman	(draft)	Date	7/7/87
M/FM:EOWens	ESO	Date	7-28-87
AFR/CONT:TRattan	[initials]	Date	7/27/87
AFR/PD/EAP:TLofgren	(draft)	Date	7/21/87
AFR/EA:SMintz	[initials]	Date	7/27/87
DAA/AFR/ESA:LSaiers	[initials]	Date	8/5/87

Drafter: AFR/PD/EAP:DPrindle, 6/16/87, Doc # 2989J

PROGRAM ASSISTANCE APPROVAL DOCUMENT

I. SUMMARY

A. Economic Overview

Somalia is one of the poorest countries in Africa, with a per capita income of less than $300 per year. The country entered 1987 with an external debt of $1.9 billion and arrears on 1986 debt service payments exceeding $150 million by latest estimates. The external debt exceeds GDP and the arrears for 1986 exceed 1986 exports by over 50%. The latest estimates provided at the Consultative Group meeting in Paris in early April, 1987, estimate a need for combined donor grants and loans plus rescheduling at $580 million for the GSDR to meet 1987 target levels. Debt rescheduling in 1987 will be essential to avoid default. To date this calendar year, the GSDR has avoided Brooke Alexander sanctions, on five FMS loans due in 1986, only by making payments on the date due or the previous day. Twice, the payments were made by purchasing foreign exchange from the Central Bank or free market with shillings generated from USAID programs. There will be at least one, and probably three more FMS loans and several AID loans due before debt rescheduling can be completed.

Despite the reforms of the previous six to eight years, Somalia cannot overcome the massive debt or the trade imbalance without donor assistance. With such a large external debt, unrescheduled debt service payments will continue to exceed exports plus remittances. Somalia needs large amounts of donor assistance and yearly debt rescheduling to finance the trade deficit and to meet whatever debt payments are possible. Without assistance, the country will necessarily default on debt payments and imports of critical materials will either not arrive or will be sufficiently delayed to disrupt the economy.

The country has a large trade imbalance, with yearly exports being only one third to one fourth imports. This is expected to continue. With few natural resources and almost no industry, the trade deficit cannot be eliminated easily. In addition, the country entered this decade with a large and growing external debt, accumulated during a war with Ethiopia followed by a severe drought. Somalia does not have the large, potential export capacity of countries with a mineral base, e.g., copper or petroleum. Nevertheless, it still has the problems associated with dependence on one sector for export receipts. This became very apparent in 1983 when Saudi Arabia banned all livestock imports from Somalia. Although the ban was later modified to include only cattle, the recovery efforts are still being slowed by this action. Approximately 70% of Somalia's export receipts come from livestock and both an increase in livestock exports and diversification are essential, though difficult to achieve.Indeed, livestock exports may be declining.

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Since 1978, Somalia has moved from a socialist system in which virtually 100% of industry was government owned or controlled to an essentially free enterprise, market-oriented economy. Almost all price controls have been eliminated with key exceptions such as petroleum and articles produced by Government enterprises or parastatals. There are also very few import or export monopolies, though some do exist in key areas.

Although Somalia suffers from many economic difficulties, including inflation, a large domestic budget deficit, inadequate budgeting practices, and a low rate of tax collections, the basic problem we are attempting to address through ESF assistance is the balance of payments deficit. The current account deficit is regularly around $300 million each year. It is projected at $350 million for 1987. Even with anticipated donor assistance, there is a deficit in the combined current and capital account in the balance of payments.

B. Foreign Exchange Regime

The GSDR opened a free foreign-exchange market in January, 1985, making foreign exchange available through a market-determined mechanism. The Government retained an over-valued official rate, used for Government to Government transactions and a few other activities, but has devalued the rate frequently. For a period of time, a third rate-- the Commercial Bank Rate-- existed. This rate was used for special transactions but for most purposes was inapplicable. It has now merged with the official rate. Both the public and private sectors have access to the free market, and the public sector has gone to the free market on several occasion to purchase foreign exchange for debt payment. As a result of the opening of the free market, most foreign exchange is now allocated through a market determined mechanism, and the increased shilling return has increased incentives to export. (There is still an export tax and until unification, the regulation requiring that 50 percent of all exports be surrendered at the lower official rate will remain. Nonetheless, the return to exporters is greater with the free market than without and should be greater under the proposed unified system.) The GSDR has resisted unification for some time, however, in the hope it can obtain adequate foreign exchange at a cheap, highly over-valued official rate.

The market has worked well in allocating foreign exchange, but the rate is high and at times has been affected by speculation, making it difficult for importers to purchase free-market foreign exchange and sell the goods in shillings for a profit. The free market opened in January 1985 at a rate of about SoSh 1 = $.01136 (SoSh 88 = $1), rose to SoSh 1 = $.00869 (SoSh 115 =$1) by January 1986, and to SoSh 1 = $.00645 (SoSh155 = $1) by June 1985. It went down to approximately SoSh 1 = $.00833 to $.008 (SoSh 120 to SoSh 125 = $1) for a brief period in August when it became apparent that there would be a cash auction. Thereafter, throughout 1986, the rate on external accounts rose to between SoSh 1 = $

.006896 to $ .0066 (SoSh 145 to SoSh 150) and the rate for import and export promotion accounts remained around SoSh 1 = $.007 (SoSh 135 = $1). Indeed, the value of the shilling adjusted for inflation actually increased during 1986. This situation lasted until January, 1987, when the rates rose to almost the level of June of 1986 and after a slight drop has continued to rise. Despite the Government's desire for an over-valued exchange rate, however, and the knowledge that the free-market rate could prove significant in determining a unified rate, the GSDR has refrained from manipulating the free market during its over two years of existence, even during periods of sharp devaluation.

A realistic exchange rate, with correct "pricing signals" to exporters and importers, is critical to alleviate current balance of payments problems. Somalia needs to encourage exports of livestock. New industries, both export and import substitution, are also needed. Unnecessary importation needs to be curtailed. All of these objectives will be fostered by maintaining a "realistic" exchange rate. Without a "realistic" exchange rate, the other pricing and marketing reforms will have little impact. Indeed, the newly opened Egyptian market for cattle would not have been profitable without the large devaluation in the shilling in the past two years.

C. Donor Cash Auctions

Donor cash auctions began September 1, 1986, with World Bank funding. The auctions were augmented with Italian aid and USAID funds in February 1987. Despite the fact that donor-auction foreign exchange has sold at a discount, the auctions have supported the free market and helped give the correct "pricing" signals. In addition, the present auction rate compares favorably with the free market after adjusting for the limitations placed on auction foreign exchange. Auction foreign exchange is probably no longer subsidized.

Although the auctions have not been free of imperfections, they have run extremely smoothly and honestly administratively. Equally important, public confidence in the integrity of auctions has steadily increased since their inception. Despite the GSDR desire for a low auction rate, the Government has increased the amount of foreign exchange above the donor-approved amount only three times. Two times, the GSDR injection of funds was made to keep the auction volume at the level it had been for previous auctions. The third time, the Minister of Finance thought he had World Bank/Washington concurrence on the increased amount.

Although the Somalis would like the same quantity of foreign exchange at a lower price, the auctions have given them confidence that a steady supply of foreign exchange will be available to anyone willing to bid sufficiently high. For several months prior to the start of auctions, the public and GSDR officials perceived that foreign exchange might not be available at any price. The auctions have dispelled this belief.

D. Proposed Unification

The GSDR is supposed to unify the official and free market exchange rates as part of a package for a new IMF Agreement. Unification was originally supposed to take place before the end of 1986. USAID has been pressing for use of a market-determined mechanism for determining the exchange rate under a unified system. Both the IMF and GSDR have been opposed to unification at a free-market rate. Initially, the proposal most favored by the IMF was a system whereby the shilling would be "pegged" to a market-basket of currencies, but the initial rate of the shilling versus the value of the market basket would have been negotiated and most likely unification would have begun at an over-valued rate, thus remaining over-valued. The mechanism proposed for adjusting the value of the shilling was periodic adjustments based on relative inflation between Somalia and her major trading partners. This mechanism would have maintained the "correct" value of the shilling in some respects--assuming the initial rate for unification was accurate--but would not have allowed adjustments for other factors affecting the value of the shilling.

USAID conditionality and policy dialogue helped convince the Minister of Finance and Central Bank Governor of the importance to the economy and to development of maintaining a market-determined rate. Although we would prefer maintenance of the existing free market arrangement, we have indicated consistently to the GSDR and IMF that unification through a well-run auction would be acceptable. In December, 1986, the IMF offered the GSDR two main proposals for unification. One involved using an auction mechanism for setting the exchange rate. Under the other, the exchange rate would be determined through pegging the shilling to a market-basket of currencies, as described above.

USAID conditionality in the FY86 ESF Agreement contained a provision requiring USAID concurrence on any change in the exchange regime that involved closing the free market. Government officials have known of our preference for the auction mechanism over a pegged exchange system since we consider the former to be more market-determined and think the rate will remain closer to a true market rate. They have also known that we would accept the auction as an alternative to the free market if the auction were well run. The GSDR has chosen to use an expanded version of the present donor cash auctions for allocating foreign exchange for importation and for determining the exchange rate for other transactions, including those of the GSDR. There would be a separate auction for funding services and a brief period during which petroleum was valued for import, though not sales, purposes at SoSh 1 = $.0095 (SoSh 105 = $1). The GSDR intended to begin unification with the April 16 cash auction, but the exhaustion of donor funding coupled with seasonal lows in export proceeds will delay unification. Unification of exhange rates was part of the 1985 IMF Agreement. It will now occur as soon as there are either sufficient donor funds or export proceeds to sustain the auction.

E. <u>Proposed FY87 ESF Program</u>

The program purpose is to support Somalia's structural adjustment program for foreign exchange rate unification through an auction mechanism. We propose to support this important reform and structural adjustment program and consequently alleviate the balance of payments difficulties through two mechanisms: (1) giving $3 million to $5 million to the public sector for critical public sector needs (debt payment, payment for embassies abroad, or purchase of petroleum. (An example of a critical debt payment would be repayment for a bridge loan made to pay IMF arrears. Payment of IMF arrears was crucial for implementation of an IMF Agreement which can monitor a unified auction system and ensure it is well run.) (2) using the remaining $10 million to $12 million of ESF funding for the cash auction. We consider it essential to give the GSDR all the support possible in maintaining its reform of the exchange regime and ensuring sufficient foreign exchange to keep the system operating. Adequate and stable supplies of foreign exchange are essential for sustaining the system and avoiding the type of speculation that was so apparent in the free market the first half of 1986.

The proposed cash grant to the public sector results from a cash flow problem, not a decision that public sector needs exceed those of the private sector. Indeed, the public sector needs are too great to be met completely by donors. It is partially for this reason that debt rescheduling is essential. Giving all of our ESF funds to the public sector would probably still not enable it to meet its cash needs and would give little leverage. We can, however, make a significant contribution to the auction, financially and psychologically. In addition the GSDR has a commitment to the auction and would like stable and assurred sources of funding for the auction. Furthermore, the GSDR will now be receiving all export proceeds and placing up to fifty percent of them in the auction. Consequently, extra funding to the cash auction from donors releases export proceeds that the IMF and GSDR would have earmarked for the auction.

Regarding public sector need, there is, however, a definite problem of timing. The main export season will not begin for several months, and the public sector simply does not have and has not had the cash to pay important debts to multilaterals, including IMF arrears needed to get an IMF program started. There are also other critical debts falling due at this time. Other critical public sector needs such as rent on embassies and purchase of petroleum have also needed to be postponed because of the seasonal shortage of foreign exchange available to the public sector. We believe we can best support the reform in the <u>exchange</u> regime by providing cash directly to it, by conditionality aimed at maintaining a sound system, and by helping the GSDR make critical debt payment or other purchases necessary to maintain a stable economy and promote establishment and maintenance of sound auction procedures.

Our support to the auction system is predicated on the belief that the auctions have proved to be a good mechanism for assisting the private

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sector and will prove one of the best mechanisms for unifying exchange rates. The expanded auction system will differ slightly from the existing system. USAID funds will still be placed in a GSDR/USAID account in a U.S. bank for use only for verification of letters of credit approved by the World Bank Procurement Unit. Unless the situation changes significantly, we no longer anticipate commingling USAID funds in a concentration account with World Bank funds and/or GSDR export proceeds as was done with FY86 ESF funds.

USAID funds will be auctioned along with World Bank Funds and Somali export proceeds. Essentially the same auction rules will apply for all funds since some auctions will have more funding from one source than will another. Varying auction regulations according to source of funding would result in different auctions having different regulations, something to be avoided at all costs. A.I.D. funds will only be used to open letters of credit for Code 935 countries, however. Channeling A.I.D. funds to only these countries will be the responsibility of the correspondent bank verifying letters of credit. Any letters of credit opened for purchases from other countries will be channeled to other sources of auction funding. Since virtually all letters of credit opened under the auction since its inception September 1, 1986, have been with Code 935 countries, we do not consider this restriction to be one which will affect the auction outcome or significantly increase auction recordkeeping.

We do not believe there should be any other restrictions on use of auction funds, however, as restrictions lessen the ability of the auction to approximate a free market-mechanism for allocating foreign exchange. For instance, the Minister of Agriculture contention that the food imported through donor auctions has hurt farmers is not borne out by a recent World Bank study, now in final preparation. Indeed, if anything, it is the existence of subsidized donor food and the timing of any donor food which is the determining factor. Food imported, and sold, at market prices has not been a problem for agriculture. The only exception is possibly the infant rice industry, which may never be competitive. Since it is not likely to be competitive, we would also not recommend limiting rice importation or raising the tariff. Such actions would result primarily in raising the price of rice to the average, very low income Somali at the benefit of a small number of farmers.

There is an additional reason for avoiding differing regulations for USAID funding. Within a given auction, widely differing regulations for different sources of funding would not only complicate auctions, but could result in some funds going unclaimed. Certainly, this would be the case with U.S. funds tied to U.S. procurement regulations. The Italians were able to tie their funds to Italian procurement only because of the very small size of their contribution, especially when compared to imports from Italy, which has long been a source of import goods for Somalia. The Italian contribution per auction was set at a level to ensure it was less than the smallest percentage of auction goods purchased from Italy after auctions stabilized. In addition, the World Bank agreed to reimburse Italy for any excess of Italian funds contributed over purchases from Italy. There is at present no distinction in auction bidding regarding the source of funds.

E. Conclusion

Donor funding in an auction mechanism would not only augment the supply of funds but would assure a more steady flow of funding throughout the year. We have been pressing for maintenance of the free market following unification, or, at least, a mechanism which keeps the exchange rate "realistic." We view an auction mechanism for financing imports as a positive step and would actively support USAID funds going into a pool of funds to be auctioned under conditions similar to the present auction but somewhat broader in scope. Present plans call for a separate auction to fund services, with the foreign exchange coming from a variation of the present external accounts, which are financed by funds originating outside Somalia, e.g., remittances. While we would prefer to see services included under the same mechanism as imports, we consider the proposed system for providing funding for services to be workable and consider there is a good probability the two systems will eventually be merged. (See Annex B for a summary of auctions to date and an evaluation of them.)

Although a program designed primarily to assist with short term balance of payments problems cannot establish the framework needed for long term structural adjustment, Somalia's problems are not short term, and measures designed to sustain the country only from one year to the next will not produce lasting growth. The ESF program in Somalia in the past has been relatively quick disbursing, and this will be also. Nevertheless, the program is not focusing solely on relieving short run problems -- in this case, 1977-78 balance of payments deficits. The program is designed to focus on these objectives. Somalia is, however, in a position of having a yearly balance of payments crisis. Without policy change and general structural adjustment, the need for massive yearly assistance will continue. Although conditionality and reform are generally an integral part of an ESF program, Somalia's problems are more acute than those of many countries given the size of the debt relative to GDP and the dirth of natural resources. Additionally, unlike many other countries, Somalia did not start independence with a smoothly functioning public sector and infrastructure left from colonial days. Consequently, through policy reform conditions of the program, in conjunction with long term projects, we are trying to improve the general efficiency of the economy. The program, itself, is also focused on trying to promote private sector growth through market determined mechanisms in the hopes this will have more lasting implications. We believe a "realistic" exchange rate is essential for private sector growth and economic recovery.

II. STATUS WITH THE IMF

A. Present Situation

The extension to Somalia's 1985 IMF Agreement ended September 30, 1986. A follow-on agreement was not concluded in 1986 and consequently the year ended without a Paris Club debt rescheduling session and with arrears on 1986 debt of over $150 million ($172 by estimates provided at the Consultative Group meeting). After lengthy negotiations over a new agreement, beginning in July 1986, continuing during the IMF-IBRD annual meetings in Washington D.C. in September, 1986, and followed by IMF team visits to Somalia in December, 1986, and March, 1987, the GSDR and IMF have now agreed on a program which will go to the IMF Board in June, now that Somalia has obtained a bridge loan for financing the arrears due the fund.

Somalia owed the IMF approximately $29 million. The Italian Government provided approximat-ly $7 million dollars. The remainder was obtained by a bridge loan. A portion of this loan will be repaid with all or a portion of the first tranche of funding due Somalia under the new Standby and the Special Facility for Africa. This will be around $16 million.

B. Background

Somalia entered into an IMF Agreement in early 1985. The country fell into "arrears" with the 1985 Standby in July, 1985. A major reason for the temporary failure of the 1985 Standby was GSDR reluctance to unify the official and free-market exchange rates at any rate other than the highly over-valued official rate. When the GSDR ceased efforts to devise a formula for unification, it also ceased making required payments to the Fund, and thus fell into arrears.

By January, 1986, the GSDR began seriously to re-negotiate the 1985 Standby. An extension, rather than a new agreement, was desired because the GSDR would have lost remaining drawing rights under the 1985 Program (approx. $10 million) had a new Agreement been negotiated. Without those additional drawings, Somalia would have found it virtually, if not totally, impossible to make the required $25 million due the IMF, just to get a new agreement on track.

The GSDR began the required SoSh 4 per dollar monthly devaluation of the shilling in January, 1986 (with an initial devaluation of SoSh 12), and planned to pay the $25 million arrears in February, 1986. Had this been accomplished in February, 1986, the Extension would have run through June or July of 1986. Because of difficulties obtaining the full amount of funding, the GSDR and IMF did not sign the Extension until May, 1986, and the extention ran through September 30, 1986. A.I.D.'s decision to give a portion of its FY86 ESF program as untied cash to the public sector was made during this period as the seriousness of the public sector's foreign exchange shortage and the need for flexible funding sources became apparent.

III. MACRO-ECONOMIC SITUATION

A. Background:

-1. Economic Overview of Somalia: Somalia is a large but sparsely populated country of 5.6 to 5.8 million people (excluding refugees, who are estimated to be around 700,000). The natural resource base is extremely limited, with no known minerals or fossil fuels. Its low and irregular rainfall and rugged terrain, including a hot and arid coastal plain, rugged mountains and plateaus and lowlands of varying rainfall and fertility, create a harsh and fragile environment for agriculture. The climate is harsh, and the country suffers from periodic droughts. About 13 percent of the land is considered arable, but due to a lack of physical and social infrastructure, and with water being a limiting constraint, hardly 10 percent (or 1 million hectares) of potentially arable land is actually being cultivated, mostly under rainfed conditions. About half of the people are nomads and semi-nomads who depend on livestock for their livelihood, and they are concentrated in the central and northern regions. Roughly one-fourth of the population are settled farmers, most of whom are found in the southern Shebelli and in the higher rainfall Bay region. The remaining quarter of the population are engaged in various non-agricultural occupations and live mostly in urban areas. The urban population is largely concentrated in towns along the southeastern coast, with nearly 1,000,000 people living in Mogadishu.

Somalia suffers from serious institutional weaknesses in both public and private sectors. There is a critical shortage of skilled labor and of people with technical and managerial expertise, but there is apparently an excess supply of school leavers at almost every level of education and this reflects a serious imbalance between the output of the educational system and the needs of the economy. The adult literacy rate is estimated to be around 40 percent, and the primary school enrollment ratio is about 17 percent. Language fragmentation within the education and training sector and the lack of a coherent long-term language policy has seriously inhibited the efficient, effective development of human resources. The language did not exist in written form until 1973, increasing the difficulties of education and communication.

The population is growing at an annual rate of natural increase of around three percent. Emigration, mostly to the Gulf states, results in a national population growth rate of 2.8 percent, which will cause the nation's population to double within 25 years. Since the existing rangeland is already strained, its carrying capacity cannot accomodate the expected increase in nomadic population over the next 15 to 20 years, and a central development task is to absorb a much larger share of the population increment in settled agriculture and non-agricultural activities.

With an estimated 1985 per capita income of about $260, Somalia is among the poorest countries in the world. Its crude death rate of 20 per thousand and infant mortality rate of 150 per thousand live births are among the highest in Sub-Saharan Africa. About 25 percent of all children die before they are five years old, and average life expectancy at birth is only 46 years. Maternal mortality is estimated at 1,100 per 100,000 live births, compared with 82 in Egypt. Impure water supplies, inadequate waste disposal, poor food hygiene, and lack of modern health care, which is almost entirely confined to urban areas, all contribute to the high mortality rate.

As of 1955, over 55 percent of GDP originates in the agricultural sector, with about 40 percent of GDP coming from livestock, nine percent in industry (including six percent in manufacturing), and about 33 percent in services. There has been little change since then. Livestock production accounts for about 40 percent of GDP and provides around 75 percent of export earnings, making the country vulnerable to outside influences. (See Graphs 1 and 2) Crop production contributes about 12 percent of GDP and 15 percent of export receipts. Rainfed crop production is based primarily on sorghum, while the relatively small areas of controlled irrigation specialize in bananas (an important export crop providing approximately 15 percent of export proceeds), sugar cane, maize, and rice. Despite the long, 3,000 km coastline, fishing generates only two percent or less of exports, about .5 percent of GDP and two percent of employment. (See Table 1 for information on GDP by sector.)

Somalia's crop production increased remarkably for about three consecutive years - 1984 and 1985, and increased further in 1986, due mainly to a fortunate combination of favorable weather and improved production incentives after the liberalization of agricultural prices and marketing arrangements. In the recent past, the combination of factors has been mainly favorable. With the almost spectacular increase in foodgrain crop production and the recovery of livestock production after the drought of 1983, the agricultural sector led a real growth rate in overall GDP of perhaps 3 to 6 percent in 1984 and 1985. (Somalia does not have any official national accounts, and production data are collected largely through ad hoc, limited surveys. The information base is therefore very weak and no better than guesses, especially for the large livestock sector.) Estimates of real annual growth rates of GDP and its key component sectors vary widely by source-- Central Statistics Department, the IMF, and the World Bank-- and must be viewed with a great deal of caution. The World Bank, however, has concluded that real GDP probably grew at an average annual rate of around 5.0 percent between 1981 and 1985, despite large annual fluctuations within individual sectors. In the recent past, the economy has responded to a changing policy environment and favorable weather in positive ways, resulting in agricultural growth, lower inflation, and recovery of exports. However, the effect of these positive developments on key macroeconomic imbalances has been relatively small, because those imbalances were so enormous and deeply entrenched from the beginning.

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Table 1. Somalia: Gross Domestic Product by Sector, at Factor Cost (Millions of Current Somali Shillings)

	Shillings:	Percentage of Total:		
Sector	1984	1985	1984	1985
Agriculture	35,652.8	52,727.7	57.1	57.6
Crop Production	5,999.5	11,015.8	9.6	12.0
Livestock	25,444.9	35,882.8	40.7	39.2
Forestry	3,795.6	5,343.4	6.1	5.8
Fishing	412.8	485.8	0.7	0.5
Other commodity sectors	5,475.0	8,088.7	8.8	8.8
Mining and Quarrying	211.4	291.5	0.3	0.3
Manufacturing	3,399.0	5,435.0	5.4	5.9
Electricity & Water	383.6	169.3	0.6	0.2
Construction	1,481.0	2,191.9	2.4	2.4
Distribution services	9,886.8	14,625.7	15.8	16.0
Transportation & Commun.	3,795.6	5,598.8	6.1	6.1
Trade, Hotels & Rest	6,091.1	9,026.9	9.8	9.9
Other Services	11,439.3	16,076.0	18.3	17.6
Real Estate/ Insur./Bank.	4,804.4	6,874.3	7.7	7.5
Government Services	4,792.4	6,578.6	7.7	7.2
Other	1,842.4	2,623.1	3.0	2.9
GDP at Factor Cost	62,453.8	91,518.1	100.0	100.0
Indirect taxes	2,537.1	4,899.3	4.1	5.4
GDP at Market Prices	64,991.0	96,417.4	104.1	105.4

Note: 1985 estimates are preliminary.

Source: World Bank, "Somalia, Recent Economic Developments and Medium-Term Prospect, Report No. 6542-SO, Feb. 10. 1987. p. 79

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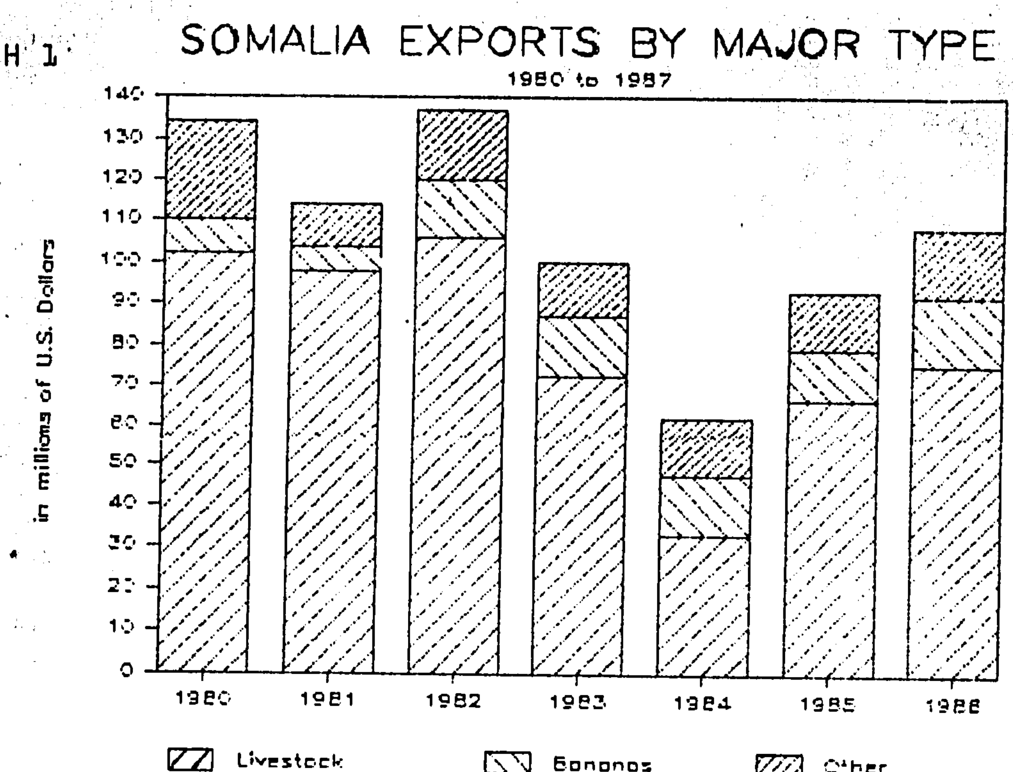
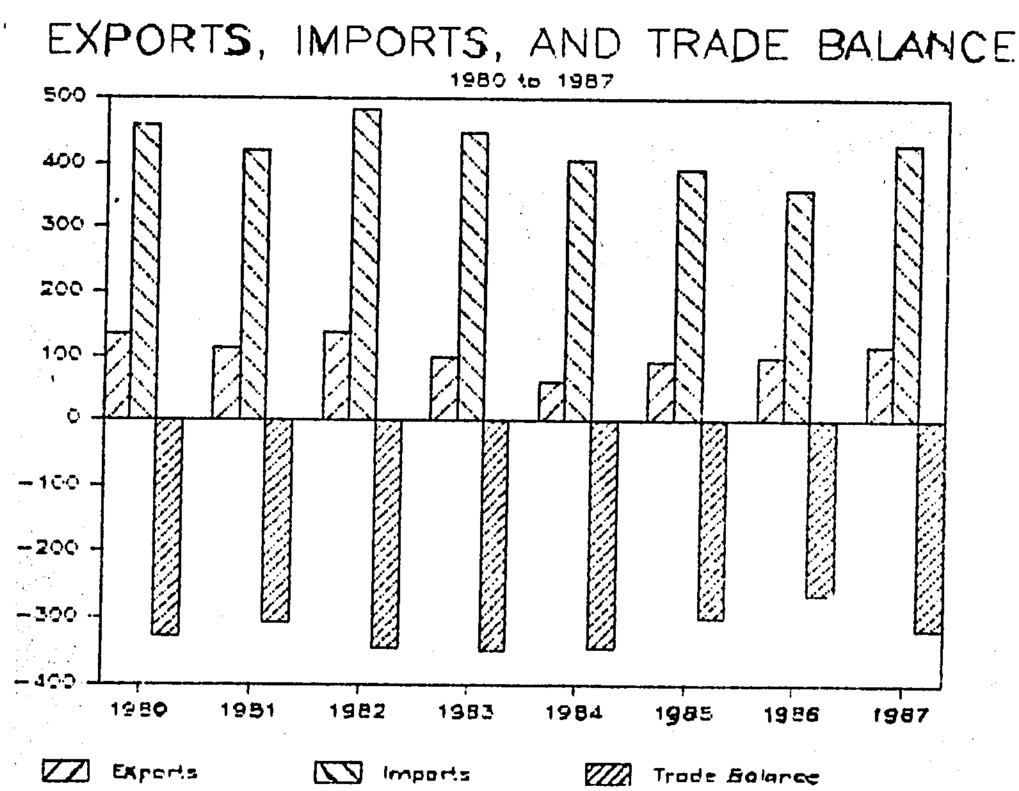
GRAPH 1



Sources: Data for 1980 through 1984 are from "Somalia - Review Under Stand-by Arrangement and Request for Waiver of Performance Criteria," IMF, April 25, 1986, Tables 5 and 9. Export breakdown for 1984 and 1985 is estimated. Data for 1985 and 1986 are from "Somalia - Staff Report for the 1986 Article IV Consultation, "August 27, 1986.

GRAPH 2



Sources: Data for 1981 through 1985 are from "Somalia - Review Under Stand-by Arrangement and Request for Waiver of Performance Criteria," IMF, April 25, 1986, Tables 5 and 9. Data for 1986 and 1987 were provided at the Consultative Group Meeting in Paris, April, 1987, and are preliminary data.

Future gains may be more difficult, and the recent drought has definitely set back growth. The long-term implications of the drought, with its effect on livestock and the short, unproductive growing season have yet to be determined. The GSDR policy regarding the impact of the drought on livestock and the carrying capacity of the rangelands will be important to note. In addition, in determining policy, it is important for the GSDR and donor community to note that periodic droughts are a virtual normal occurrence and must be dealt with that way in the long run.

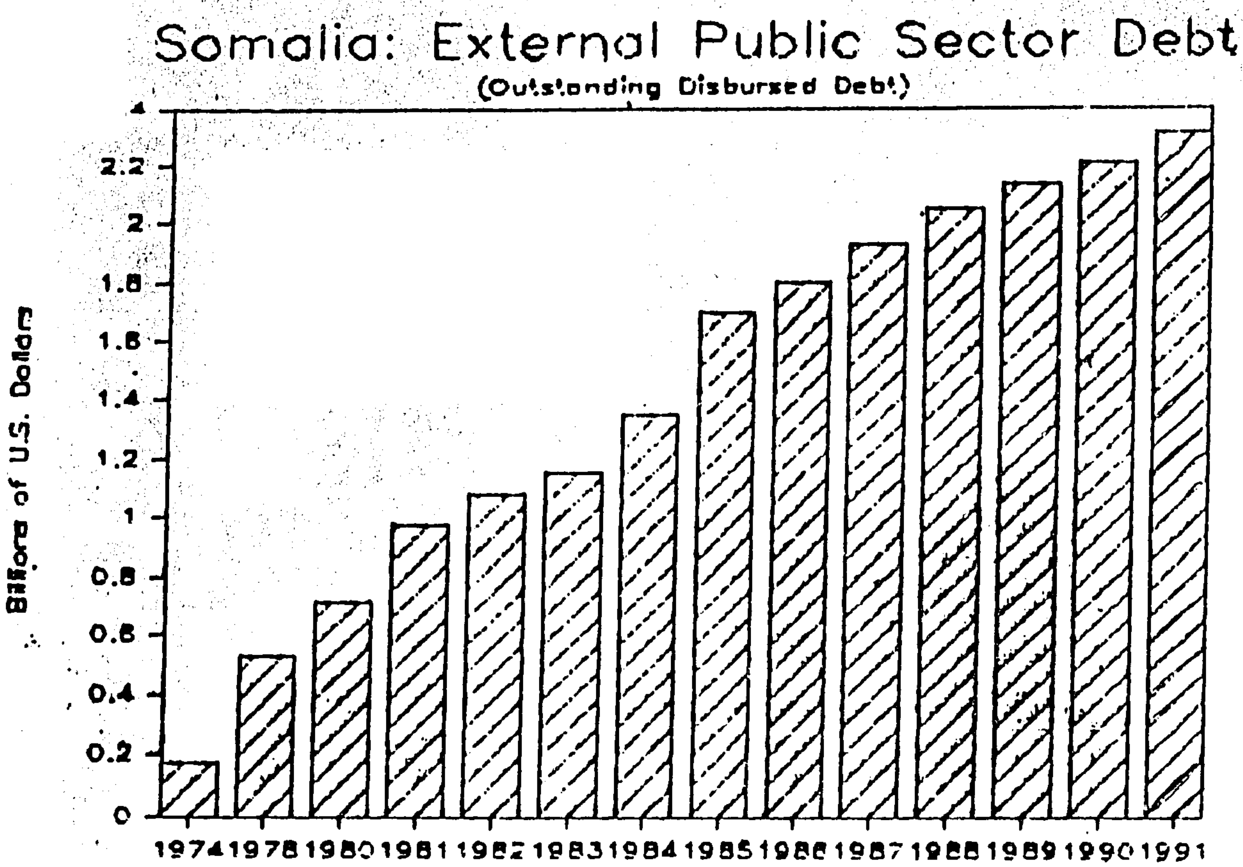
-2. Source of Somalia's Economic Difficulties and Prognosis for The Future: Somalia's economic difficulties emanate from policies begun in the socialist era of the 1970 and debts incurred during a 1977-78 war with Ethiopia. Periodic droughts have exacerbated the situation. The Saudi ban on livestock imports from Somalia in 1983 added to an already staggering burden. Since the late 1970s, Somalia has tried to improve the economic situation by a series of measures aimed at privatization of the economy. Many government owned factories and industries were turned over to the private sector. Virtually all price and import controls have been lifted with the exception of those on government owned or controlled enterprises. (See Section III E for policy reforms) Nevertheless, the country has a long way to go.

Livestock production as a percentage of GDP and export proceeds have been a mainstay for Somalia for sometime. The need for diversification became apparent in 1983 when the Saudi ban on Somali livestock imports resulted in an over 50% drop in export proceeds between 1982 and 1984. (See Graphs 1 and 2) The recovery program slowed considerably because of this reduction in foreign exchange earnings. Somalia has begun to diversify in terms of finding alternative outlets for livestock exports and increasing banana exports. Livestock and banana exports together, however, continue to be the mainstay of exports, particularly livestock, and livestock output is more likely to decline than increase. Continued reform, improvements in agricultural production, and diversification and an expanded industrial base are essential. In addition, periodic drought must be considered a reality and factored into any program, and the permanent impact of increased livestock production on the fragile rangeland must be considered.

B. Foreign Sector

-1. External Debt: The balance of payments and debt service situation remain extremely precarious, despite some improvement in 1985 over 1985. The lack of rescheduling in 1986, however, worsened the debt service problem. Somalia suffers from a large debt and a severe balance of payments deficit that will continue for more than a decade. The external debt is $1.9 billion and increasing. (See Graph 3 for debt from 1974 to 1991, Table 2A for debt service payments by year, broken out by principal and interest, and Table 2B for time series information on total public

GRAPH 3



Sources: Staff Report for the 1986 Article IV Consultation, IMF August 27, 1986, for years 1984 through 1991. For 1974 to 1983, various IMF reports.

TABLE 2A

Somalia: External Public Sector Debt Transactions, 1984-1991 (in millions of U.S. dollars)

	1984	1985	1986	1987	1988	1989	1990	1991
External debt	1,348	1,677	1,796	1,926	2,049	2,135	2,211	2,306
Non-IMF (Excluding gap)	1246	1535	1571	1603	1644	1708	1799	1886
IMF	102	142	136	108	72	37	22	20
Financing gap (cumulative)	--	--	89	215	333	390	400	400
Debt service payments								
Principal payments	64	61	96	77	86	84	70	61
Non-IMF (excluding gap)	61	45	69	49	50	49	55	59
IMF	3	16	27	28	36	35	15	2
Interest payments	44	49	62	59	64	66	73	77
Non-IMF	39	36	47	40	43	45	53	59
IMF	5	13	13	10	8	5	4	2
Financing gap	--	--	2	9	13	16	16	16
Debt service (accrual basis) (1)	108	110	158	136	150	150	143	138
Arrears accumulation	97	-65	-10	-19	-19	--	--	--
1985 debt relief (2)	--	125	-19	-18	-17	-9	-5	-29
Principal	(--)	(23)	(-7)	(-11)	(-11)	(-4)	(--)	(-24)
Interest	(--)	(20)	(-12)	(-7)	(-6)	(-5)	(-5)	(-5)
Arrears	(--)	(82)	(--)	(--)	(--)	(--)	(--)	(--)
Debt service (cash basis) (3)	11	50	187	173	186	164	148	167
Principal	4	27	109	100	108	93	76	87
Interest	7	23	78	73	78	71	72	80
Memorandum Items:								
Debt service ratio (4) (in percent								
Accrual basis	58	68	87	68	68	65	56	49
Cash basis	6	31	104	87	84	68	58	59
External debt/GDP (in percent)	111	129	112	116	118	116	118	118

Source: Somalia - "Staff Report for the 1986 Article IV Consultation" IMF August 27, 1986, Table 10 (covers medium- and long-term disbursed debt only.

(1) Scheduled payments before arrears accumulation and 1985 debt relief.
(2) Debt relief on medium- and long-term debts; repayments include service on consolidated short term debt.
(3) Actual payments, net of debt relief; also includes payment of arrears and amounts thus do not directly correspond to balance of payments data.
(4) As percent of exports of goods and services (including private transfers).

TABLE 2B

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SOMALIA: EXTERNAL DEBT SERVICE OBLIGATIONS, 1986-90 1/

(In thousands of U.S. dollars)

	1986			1987			1988			1989			1990		
	Prin.	Int.	Total	Prin.	Int.	Total	Prin.	Int.	Total	Prin.	Int.	Total	Prin.	Int.	Total
I. Organizations	47356.4	25357.9	72714.3	74094.3	22032.5	96126.8	82555.3	20695.3	103250.6	59522.9	14934.1	74457.0	39504.1	11944.3	51448.4
A. Multilateral	40143.0	22569.8	62712.8	64521.1	19140.1	83661.2	72982.1	17851.5	90833.6	49949.7	12236.6	62186.3	29612.6	9409.6	39022.2
African Dev. Bank	406.9	438.0	849.9	677.9	567.2	1245.1	677.9	498.0	1176.0	677.9	428.9	1106.9	667.9	359.8	1027.7
African Dev. Fund	67.5	257.2	324.7	76.1	329.5	405.6	132.1	361.6	493.7	186.6	366.4	553.0	333.0	364.8	697.8
Arab Fund	3753.3	3895.4	7648.7	5643.2	2665.3	8308.5	6468.8	3249.7	9718.5	5828.9	3721.6	9550.5	7012.6	3750.8	10763.4
European Invest. Bank	0.0	28.4	28.4	0.0	36.7	36.7	202.2	39.5	241.7	204.1	38.5	242.6	784.6	37.5	822.1
IDA	863.3	1637.2	2500.5	1136.9	1724.7	2861.6	1303.1	1746.3	3049.4	1427.2	1744.9	3172.0	1629.2	1739.8	3369.0
IFAD	0.0	173.5	173.5	0.0	228.4	228.4	0.0	247.8	247.8	94.0	271.4	365.4	355.7	279.3	635.0
Islamic Dev. Bank	423.5	211.1	634.6	423.5	200.7	624.2	423.5	190.4	613.9	423.5	180.0	603.5	377.1	171.0	548.1
OPEC Fund	3502.5	135.0	3637.5	3502.5	116.6	3619.1	3502.5	98.2	3600.7	3502.5	79.9	3582.4	3502.5	61.6	3564.1
IMF(incl. Trust Fund)	28493.0	12894.0	41387.0	29785.0	10350.0	40135.0	38295.0	8395.0	46690.0	37605.0	5405.0	43010.0	14950.0	2645.0	17595.0
Arab Monetary Fund	2633.0	2900.0	5533.0	23276.0	2921.0	26197.0	21977.0	3025.0	25002.0	0.0	0.0	0.0	0.0	0.0	0.0
B. Bilateral	7213.4	2788.1	10001.5	9573.2	2892.4	12465.6	9573.2	2843.8	12417.0	9573.2	2697.5	12270.7	9891.5	2534.7	12426.2
Kuwait Fund	1313.1	1222.6	2535.7	3672.9	1354.9	5027.8	3672.9	1383.6	5056.5	3672.9	1337.3	5010.2	3991.2	1278.6	5269.8
Saudi Fund	5900.3	1565.5	7465.8	5900.3	1537.5	7437.8	5900.3	1460.2	7360.5	5900.3	1360.2	7260.5	5900.3	1256.1	7156.4
II. Countries	61396.8	39254.1	100650.9	62881.5	30141.5	93023.0	65305.0	27316.0	92621.0	64675.3	24856.6	89531.9	63151.3	22197.5	85348.8
A. OECD countries	22020.2	19574.1	41594.3	20848.4	18898.9	39747.3	22090.0	17695.8	39785.8	24576.6	16380.5	40957.1	25241.5	14829.0	40070.5
France	2313.0	3533.7	5846.7	2775.7	3477.1	6252.8	3528.0	3035.3	6563.3	3591.0	2724.8	6315.8	3074.5	2275.8	5350.3
Italy	16672.7	6386.0	23058.7	15031.1	6024.6	21055.7	14948.7	5353.0	20301.7	17364.7	4670.2	22034.9	17968.7	3835.0	21803.7
Japan	0.0	44.8	44.8	0.0	149.5	149.5	0.0	329.0	329.0	0.0	394.3	394.3	0.0	394.3	394.3
USA	3034.5	9609.6	12644.1	3041.6	9247.7	12289.3	3613.3	8978.5	12591.8	3620.9	8591.2	12212.1	4198.3	8323.9	12522.2
B. Other	21693.3	8287.8	29981.1	24168.7	4537.1	28705.8	25350.6	3466.8	28817.4	25083.5	2874.9	27958.4	27109.6	2141.2	29250.8
Abu Dhabi	10125.0	2858.7	12983.7	10125.1	2453.7	12578.8	10125.1	2048.7	12173.8	10125.1	1643.7	11768.8	10125.1	1238.7	11363.8
Algeria	100.0	14.0	114.0	100.0	12.0	112.0	100.0	10.0	110.0	100.0	8.0	108.0	100.0	6.0	106.0
P.R. of China	3275.0	0.0	3275.0	8635.5	0.0	8635.5	10974.9	0.0	10974.9	10974.9	0.0	10974.9	13161.3	0.0	13161.3
Iraq	2351.1	3342.5	5693.6	2051.0	969.1	3020.1	2051.0	825.5	2876.5	2051.0	682.0	2733.0	2051.0	538.4	2589.4
Romania	4811.0	1829.0	6640.0	2225.9	939.9	3165.8	1068.4	451.1	1519.5	801.3	440.7	1242.0	641.0	288.5	929.5
Yugoslavia	1031.2	243.6	1274.8	1031.2	162.4	1193.6	1031.2	131.5	1162.7	1031.2	100.5	1131.7	1031.2	69.6	1100.8
C. Debt relief 2/	7064.3	9853.5	16917.8	7064.2	5166.8	12231.0	7064.2	4614.7	11678.9	4215.0	4062.5	8277.5	0.0	3888.6	3888.6
France	78.4	796.1	874.5	78.4	557.4	635.8	78.4	548.7	627.1	71.5	540.1	611.6	0.0	536.1	536.1
Italy	1110.4	2491.2	3601.6	1110.4	1682.4	2792.8	1110.4	1660.2	2770.6	1100.4	1638.0	2738.4	0.0	1616.5	1616.5
U.K.	5664.5	4449.7	10114.2	5664.5	1122.5	6787.0	5664.5	624.0	6288.5	2832.2	125.6	2957.8	0.0	0.0	0.0
U.S.A.	211.0	2116.5	2327.5	210.9	1804.5	2015.4	210.9	1781.8	1992.7	210.9	1758.8	1969.7	0.0	1736.0	1736.0
D. Special bilateral	10619.0	1538.7	12157.7	10800.2	1538.7	12338.9	10800.2	1538.7	12338.9	10800.2	1538.7	12338.9	10800.2	1538.7	12338.9
Bulgaria	426.5	0.0	426.5	607.7	0.0	607.7	607.7	0.0	607.7	607.7	0.0	607.7	607.7	0.0	607.7
U.S.S.R.	10192.5	1538.7	11731.2	10192.5	1538.7	11731.2	10192.5	1538.7	11731.2	10192.5	1538.7	11731.2	10192.5	1538.7	11731.2
III. Total	108753.2	64612.0	173365.2	136975.8	52174.0	189149.8	147860.3	48011.3	195871.6	124198.2	39790.7	163988.9	102655.4	34341.8	136997.2

1/ Covers medium and long-term debts only; service obligations on external debt outstanding at end-1985.

2/ 1985 Paris Club rescheduling.

Source: Ministry of Finance, External Debt Unit.

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sector debt. Tables 3A and 3B provide information on the general balance of payments situation and the overall foreign exchange gap, including the role of external debt in the overall balance of payments picture.) Table 3A is primarily from the August 27 IMF Report, based on information gathered by the IMF team in July, 1986. Table 3B was provided by the World Bank at the Consultative Group meeting in early April, 1987, and represents a slight update. Both are provided because Table 3A provides additional information not available in the updated, but condensed data in Table 3B. In addition, inclusion of both shows the changes in IMF estimates of import, export, and other figures for both 1986 and 1987 as time progressed. This is important to note when evaluating the accuracy of data projections. (The IMF is presently revising balance of payments and other tables and the information provided should therefore be treated as preliminary.)

Unrescheduled debt service payments continue to exceed exports of goods and services. The Consultative Group (CG) met in Paris in early April, 1987, which included donor pledging. Data provided by the World Bank at the CG meeting estimated debt service owed in 1987 at $157 million, or 110% of exports and private remittances. Of the $157 million, $109 million is principal and $48 million is interest charges. These figures, however, were initially based on the assumption that all potentially reschedulable debt from 1986 (i.e., all debt not owed to multilaterals) could and would be rescheduled. Some has already potentially been paid this year and consequently cannot be rescheduled. Thus, gap figures need to be revised accordingly. The Fund is trying to enable the GSDR to postpone all debt payment to bilaterals until after a Paris Club rescheduling session. Postponement of some debt is impossible.

Even with large donor pledges, Somalia will need to husband her resources very carefully to make it through 1987. Both the public sector and the private sector face a foreign exchange crunch, and sufficient foreign exchange available for both is essential for the country to move out of the present morass. Adequate foreign exchange is required by the private sector to provide the assurance industry needs to operate. U.S. assistance is thus crucial for economic development. The problem will continue for some time, as can be seen by Table 2B.

-2. <u>Imports and Exports</u>: Imports for 1987 (estimated for the CG at $490 million) continue to be three and a half to four times exports (estimated at $115 million), which come mainly from livestock, and cannot improve dramatically. Table 5 gives export data by value from 1980 to 1985. Following is the breakdown of trade for 1986 as projected by the IMF as of April, 1986, re-projected in August, 1986(from July figures), and estimated in March, 1987, in information provided at the April, 1987, Consultative Group meeting.

Table 3A SOMALIA: SUMMARY BALANCE OF PAYMENTS, 1981-1987, (in Millions of U.S. dollars)

	1981	1982	1983	1984	1985	Prog. (4/24/86) 1986	Revised (9/86) 1986(3)	Estimates 1987
CURRENT ACCOUNT BALANCE	-95	-131	-147	-145	-131	-169	-130	-141
Exports (FOB)	114	137	100	62	93	130	108	120
Livestock	(98)	(106)	(72)	(33)	(66)	(95)	(75)	(83)
Bananas	(6)	(14)	(15)	(14)	(13)	(15)	(17)	(19)
Others	(10)	(17)	(13)	(15)	(14)	(20)	(16)	(18)
Imports (CIF)	-422	-484	-450	-406	-394	-425	-407	-431
Trade Balance	-308	-347	-350	-344	-301	-295	-299	-311
Services (net)	-1	9	4	-47	-55	-82	-76	-64
(of which: interest payments)	(-10)	(-14)	(-21)	(-44)	(-55)	(-79)	(-62)	(-59)
Transfers (net) (1)	214	207	199	246	225	208	245	234
Official	150	157	148	174	205	178	225	212
Private	50	64	51	72	20	30	20	22
CAPITAL ACCOUNT (NET)	82	87	61	6	81	52	55	91
Official	79	123	100	46	119	62	75	91
Private (2)	3	-36	-39	-40	-38	-10	-20	
OVERALL BALANCE	-13	-44	-86	-139	-50	-117	-75	-50
Financing	13	44	86	139	50	117	75	50
Central Bank	33	64	47	13	28	-11	-14	-57
of which: IMF	(30)	(34)	(44)	(-3)	(32)	(-5)	(-7)	(-28)
Commercial bank	-20	-20	39	29	-32	12	10	--
Arrears	--	--	--	71	-98	-18	-10	-19
Debt relief	--	--	--	26	152	--	--	--
Financing Gap	--	--	--	--	--	134	89	126

Sources: Data for 1981 through 1984 and 1986 Program data are from "Somalia - Review Under Stand-By Under Stand-By Arrangement and Request for Waiver of Performance Criteria," IMF, April 25, 1986. Data for 1985, 1986(revised), and 1987 (est.) are from "Somalia - Staff Report for the 1986 Article IV Consultation," August 27, 1986

(1) Totals for 1981 and 1982 do not add.

(2) Includes net errors and omissions

(3) More recent, unpublished IMF statistics indicate recorded exports for 1986 are closer to $92 million, with recorded remittances increasing to $35 million. The two almost exactly offset each other. The change in the volume of exports

TABLE 3B

Somalia : External Gap Analysis 1986-1989
(US $ Millions)

	(Actual) 1986	1987	1988	1989
TOTAL FINANCING GAP WITHOUT AID				
A. Current Account Receipts	136	142	159	176
Exports	99	115	131	146
Private transfers	37	27	28	30
B. Current Account Payments :	445	490	473	480
Imports	363	431	429	444
of which :				
. Food	58	55	50	48
. Petrol	44	50	52	60
. Other non PIP	90	100	110	121
. PIP-related	173	226	217	205
Services (net)	70	59	44	36
of which :				
. Interest	(45)	(36)	(33)	(32)
. IMF/AMF charges	(16)	(12)	(11)	(6)
C. Current Account Deficit (B-A) :	297	348	314	304
D. Capital Repayments on Debt :	67	224	153	120
Repayment of Principal	57	61	55	54
Net Repurchases from IMF	7	13(a)	40	42
Net Repurchases from AMF	3	38(b)	22	-
Reduction of Arrears	-	112	36	24
E. Increase in Reserves	-14	8	7	5
F. Private Capital/Errors and Omissions	33	-	-	-
G. Total Financing Requirements (C+D+E+F) :	383(c)	580	474	430

(a) including $5 million arrear payments.
b) including $15 million arrear payments
c) official grants and loans amounted to $330 million and $80 million was financed by accumulationf of arrears.

SOMALIA BALANCE OF TRADE FOR 1986

	Initial Program (4/24/86)	Revised Program (Aug. 1986)	Estimate March/April, 1987
Exports (FOB)	$130 million	$108 million	$99 million
Livestock	(95)	(75)	
Bananas	(15)	(17)	
Other	(20)	(16)	
Imports (CIF)	$425 million	$407 million	$363 million
Trade Balance	-295 million	-299 million	-264 million

Imports and the trade balance are provided with the export data for easier comparison. As can be seen, exports were not as large as projected, though there are indications that some exports were smuggled out, with the receipts returned to Somalia through the External Account section of the free exchange market. The heavy reliance on livestock is obvious and makes the country extremely vulnerable to outside influences such as the Saudi ban of livestock imports from Somalia, the main impact of which was felt in 1984. (Graphs 1 and 2 illustrate the yearly trade deficit, the over-reliance on one sector for export receipts, and the potential difficulties of relying heavily on only one sector. Graph 1 uses the August export figures for the breakdown of commodities by type since the figures as revised for 1987-- Table 3B-- do not disaggregate the information.)

The export picture is still precarious and heavily dependent on a good supply of livestock and a market for livestock. Exports rebounded in 1985 and 1986 to nearly $100 million in the latter year, after dropping off by some 40 percent in 1984. (Table 4 shows the dollar value of exports by commodity from 1980 to 1985.) The devaluation of the Somali shilling in 1985, along with the introduction of the free market for selling part of foreign exchange earnings from exports has had a positive effect on livestock exports. Indeed, exports to Egypt would not have been profitable without the devaluation and opening of the free market. Still, cattle exports of 42,000 head in 1985 were far below the peak level of 157,000 head in 1982. (Table 5 shows the number and value of livestock exports from 1976 through 1987. There were only minor improvements in other exports.

Based on Table 4, banana exports increased dramatically from 1981 to 1982, but in 1985, exports remained officially at the 1984 level, and exports of incense, hides, and skins recovered only slightly. The collection rate of hides and skins remains low, due largely to continuing controls on pricing and marketing.

Manufacturing, which is limited primarily to such areas as petroleum refining, production of cigarettes and matches, and canning, is almost

TABLE 4

Somalia: Exports by Commodity, 1980-85
(In millions of US$)

	1980	1981	1982	1983	1984	1985
Live Animals	101.7	98.0	105.7	72.0	33.1	66.0
Bananas	8.1	6.0	14.0	15.0	14.1	13.0
Fuel Oil	9.8	-	3.9	3.0	4.3	1.6
Meat & Meat Products	1.1	0.4	-	0.2	-	-
Fish & Fish Products	0.3	0.9	3.0	2.3	0.4	0.2
Hides & Skins	7.0	2.3	6.3	1.5	3.9	4.3
Myrrh	3.7	3.7	3.7	6.3	2.4	3.9
Other	2.5	2.7	0.3	0.4	3.8	3.5
Total	134.2	114.0	136.9	100.7	62.0	92.5

Source: Somali authorities and IMF.

FROM SOMALIA: RECENT ECONOMIC DEVELOPMENTS AND MEDIUM TERM PROSPECTS, REPORT NO. 6542-SO; WORLD BANK, FEBRUARY 10, 1987

TABLE 5

Somalia: Number and Value of Livestock Exports, 1976-86

	Sheep ('000)	Goats ('000)	Cattle ('000)	Camels ('000)	Total Livestock ('000)	Total Value, f.o.b. (Millions of So. Sh.)
1976	385	381	58	34	858	301.9
1977	465	462	55	33	1,015	299.5
1978	739	715	77	22	1,553	570.6
1979	717	705	68	13	1,503	474.1
1980	745	736	143	17	1,641	639.5
1981	685	680	116	15	1,496	1,001.9
1982	730	719	157	15	1,621	1,511.9
1983	569	557	54	8	1,188	1,129.3
1984	389	362	8	4	763	670.8
1985	709	749	42	7	1,507	5,247.6
1985 2	34	34	--	--	68	...
1986 2	81	82	3	1	177	...

1/ Exchange transaction records.
2/ Through February.

Source: Ministry of Livestock, Central Bank of Somalia, and IMF.

FROM "SOMALIA: RECENT ECONOMIC DEVELOPMENTS AND MEDIUM TERM PROSPECTS, REPORT NO 6542-SO": WORLD BANK, FEBRUARY 20, 1987

TABLE 6

Somalia: Manufacturing Enterprises Performance Indicators 1983-85

	Sales (So. Sh. million)			Profit/Loss (-) (So. Sh. million)			Number of employees		
	1983	1984	1985	1983	1984	1985	1983	1984	1985
Enterprises									
1. Juba Sugar Complex	373	289	840	Loss	-52	111	1,870	1,795	2,045
2. SNAI Sugar Factory	26	26	85	-82	-89	-23	1,863	1,277	2,625
3. Oil Mill 1/	4	...	...	-1.6	...	...	80	...	...
4. Wheat, Flour and Pasta Factory	100	...	...	-7	...	...	297	...	...
5. Meat Factory, Kismayo	8	17	1	--	-1.4	-8.5	303	219	185
6. Milk Factory 1/	2	...	...	-0.7	...	...	71	...	...
7. National Bottling Company (private)	46	...	...	Profit	...	...	160	...	...
8. SNAI-BIASA 2/	22	...	...	...	...	...	227	...	...
9. Cigarette and Match Factory	941	230	746	24	26.4	36.4	595	593	595
10. Somaltex	120	119	169	-10	-6.6	1.5	1,200	1,239	650
11. Foundry and Mechanical Workshop	5	9	...	-2	-1	...	109	120	80
12. Aluminum Utensils	10	12	4	-1.5	-6.4	-0.8	85	97	155
13. Tannery Km 7	23	...	...	-5.7	...	...	304	240	264
14. Petroleum Refinery	757	...	1,522	...	31.1	-7.2	179	...	...
15. Miscellaneous	263	...	...	...	...	...	750	...	...

Sources: Ministry of Industry and Ministry of National Planning.

1/ Out of operation from 1984.
2/ Included in accounts of SNAI Sugar Factory from 1984.

SOMALIA: VALUE OF IMPORTS BY MAJOR COMMODITIES
BASED ON FOREIGN EXCHANGE RECORD
(MILLIONS OF SOMALI SHILLINGS)

ITEM		1977	1978	1979	1980	1981	1982	1983	1984	1985
FOODSTUFF	150	145.0	58.2	222.6	274.9	224.0	557.6	453.7	267.5	716.3
BEV & TOBACCO	151	44.2	62.7	62.4	48.4	15.7	57.6	112.1	79.4	43.5
TEXTILES/H.GOODS	152	16.9	34.3	26.4	20.9	23.7	22.5	36.2	37.3	70.4
MEDICINES/CHEM	153	43.5	33.8	44.3	143.7	49.4	70.0	126.1	64.4	40.0
MFG RAW MATERIALS	154	46.2	61.0	66.5	29.7	48.2	75.9	127.4	66.4	47.9
AGRI. INPUTS	155	1.7	2.7	22.8	30.5	8.4	1.4	20.0	0.2	-
PETROLEUM	156	100.7	14.5	281.3	410.3	452.4	991.9	881.5	902.7	1,496.4
CONST MATERIAL	157	41.1	29.0	49.8	32.4	58.7	203.2	336.8	193.0	653.0
MACHINES & PARTS	158	156.6	181.9	205.2	240.2	141.2	219.8	209.5	293.1	567.0
TRANSPORT & PARTS	159	125.6	126.8	342.2	236.5	128.2	157.4	211.3	145.6	594.7
FARM MACHINES	163	-	-	230.9	142.6	6.9	12.7	6.9	12.1	1.2
OTHERS	170	434.2	595.0	264.2	129.3	41.9	54.0	322.9	155.3	120.0
TOTAL	169	1,155.7	1,199.9	1,818.6	1,739.4	1,198.7	2,424.0	2,844.4	2,217.0	4,350.4

SOURCE: CENTRAL BANK OF SOMALIA
NOTE: THIS DATA IS BASED ON FOREIGN EXCHANGE DATA COLLECTED BY THE CENTRAL BANK OF SOMALIA. IT EXCLUDES IMPORTS THROUGH THE FRANCO VALUTA SYSTEM AND FOREIGN CURRENCY ACCOUNTS.

TABLE SOM/3T/10

FROM "SOMALIA: RECENT ECONOMIC DEVELOPMENTS AND MEDIUM TERM PROSPECTS," REPORT NO 6542-SO: WORLD BANK, FEBRUARY 20, 1987 non-existent, either for export or import substitution. Manufacturing accounts for less than 10% of GDP. Imports declined by 10 percent in both 1984 and 1985, due at least partly to the effect of exchange rate adjustments and they remained at the 1985 level in 1986 ($363 million, or 3.6 times the level of exports). (see Table 6)

Rising exports and declining imports contributed to a modest reduction of the current account deficit, though it still remained, in 1986, three times the value of exports.

Table 7 gives time series data on major import categories from 1977 to 1985 in shillings. Unfortunately, it excludes imports financed through the _franco valuta_ system, a procedure whereby imports were financed through an individual's own foreign exchange-- or foreign exchange he/she provided another importer. This is a sizable omission. Following is a gross aggregation of imports in dollars for 1985 and estimates, based on August 1986 projections, for 1986.

Table 8: IMPORTS OF MAJOR CATEGORIES, 1985 AND 1986

	(Imports In Millions of U.S. Dollars)	
Actual	Projection	
	1985	1986
Food	66	56
Oil	63	46
Intermediate goods	38	44
Investment goods *	164	199
Others	31	32
TOTAL (f.o.b.)	362	377

(*) Machinery and transportation equipment.

Somalia needs balance of payments assistance from donors to finance critical imports and to finance the large debt-service payments. Without year-to-year donor assistance, the economy could collapse. Even with liberal rescheduling and massive donor assistance, the country will find it difficult to avoid debt default and pay for needed imports. Additionally, balance of payments assistance to the private sector is necessary to assure market oriented development and maintain political stability.

-3. Balance of Payments Analysis

-- (a) Background: Based on the latest estimates provided at the Consultative Group (CG) meeting in Paris in early April, the trade gap between exports and imports of goods for 1987 is estimated at $316 million. The gap between imports and current account receipts (exports plus private remittances -- net services) is projected at $289 million. (See Table 3B) Estimates are currently being revised based on information provided during the March IMF visit, supplemented by information provided at the CG meeting. All figures are expected to change, particularly the disaggregation of imports into categories and information regarding debt, which affects financing requirements. Final figures will depend, among other factors, on the timing and extent of debt rescheduling and debt forgiveness.

Somalia has had a large trade deficit this entire decade and the deficit is expected to continue, even with a projected increase in exports to $146 million by 1989. (Table 3B) Private and public sector imports cannot be financed by exports and remittances alone. Donor commodity and cash aid are essential. In the absence of donor financing, the private sector at present can fund imports only from the fifty percent of export proceeds not surrendered to the Central Bank, remittances channeled through the existing free market, and the black market. Under a unified exchange regime, with an auction determining the exchange rate, foreign exchange will continue to be available at a price. This differs from the pre-1985 system where many persons without connections to the banking system or access to the black market or smuggled export proceeds could not import. In the past, lack of assured foreign exchange has hindered business activity as businesses have not had the necessary raw materials and machinery to operate efficiently.

When debt payments are added to the trade deficit, Somalia's foreign exchange picture worsens. Unrescheduled debt payments for 1986 were 110% of exports plus remittances. Even with rescheduling, the debt service ratio would likely have exceeded 50% of export proceeds. This contrasts greatly with the earlier part of the decade. Based on the February, 1987 World Bank Report, the yearly debt service ratio from 1980 to 1983 averaged only 14.4%. Following that, however, the grace period on many loans ended and large payments to the IMF and AMF began falling due.

Because of the failure to have debt rescheduling, Somalia ended 1986 with arrears of $172 according to figures provided at the CG. Excluding frozen debts owed to Abu Dhabi, Bulgaria, China, and the USSR, debt service owed in 1987 will be $157 million, of which $109 million represents principal and $48 million represents interest. In determining the impact of 1986 arrears on Somalia's External Gap for 1987, the IMF generally separates potentially reschedulable debt from non-reschedulable debt (debt owed to multilaterals such as the IMF). The amount of arrears from 1986 on non-reschedulable debt were between $45 million and $50

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million. The distinction is made on the assumption that most potentially reschedulable 1986 debt, currently in arrears, can and will be rescheduled in 1987 and therefore need not enter into the Gap Analysis. The information provided at the CG meeting estimated debt relief for 1987 at $152 million, which is almost equal to the maximum eligible gross debt relief and includes an $85 million reduction in arrears. (See Table 9)

By the end of 1986, the GSDR owed the U.S.Government almost $10 million on debt which could trigger Brooke Alexander Amendment sanctions in 1987 if still unpaid. To date, approximately $5 million has been paid, but with difficulty. During 1987, the GSDR will owe the IMF approximately SDR 35 million, which is more than the country is expected to receive in total from the Fund if/after a new Agreement is reached. The GSDR is presently between $25 and $30 million in arrears to the IMF and cannot get a new IMF Agreement or Paris Club debt rescheduling until the arrears are paid. Additional payments will be due the Fund in early June.

The large arrears for 1986, the uncertainty surrounding the extent to which debt owed in 1986 might conceivably be rescheduled in 1987, and uncertainties over rescheduling of 1987 debt make the balance of payments data more unreliable than usual. Table 3A, which is an amalgamation of April and August 1986 IMF Reports, is the most recent comprehensive data available. Table 3B provides more up-to-date information, but is less complete. Both are presently being updated but will not be available until after more analysis is made from the March, 1987, IMF visit, and the pledges made at the Paris CG are factored in. In addition, assumptions are being made concerning rescheduling, and these assumptions will affect the tables provided on overall balance of payments needs and public sector foreign exchange needs. Delays in concluding an IMF Agreement delay rescheduling and result in some debts being paid that might otherwise have been rescheduled, e.g., U.S. FMS debt.

-- (b). General Financing Gap: In determining the Gap, data from the August IMF report, based on the July, 1986, visit, and the table provided at the CG in Paris in early April 1987 are both provided and discussed because of the differences in completeness of the two reports. In addition, the IMF is in the process of revising all figures based on more complete analysis of the March visit to Mogadishu and donor pledges provided at the CG.

As of August, 1986, the IMF estimated a financing gap of $126 for 1987, (Table 2A), after already calculating $212 million of official transfers in the current account and $91 in the capital account. The gap for 1988 (not provided in Table 2A) was estimated at $118 million. The 1987 figures assumed that all arrears from 1986 that were "potentially reschedulable" would be rescheduled this year. Some of the 1986 "reschedulable" debts have been paid in 1987, however, or will be paid before rescheduling, including approximately $7 million in FMS debt owed by the beginning of June. While these and other such payments lower the total amount of arrears left from 1986, they also reduce the amount of

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TABLE 9

Somalia : Required Aid Disbursements and Commitments to Meet Financing Gap for 1987 and 1988
(US $ Millions)

	Required Disbursements		Disbursements from Pipeline		Disbursements from New Commitments		New Commitments Required	
	1987	1988	1987	1988	1987	1988	1987	1988
Project Aid	226	217	226	217	-	-	-	-
Commodity Aid	165	150	147	30	18	120	40	200
of which :								
. Food	45	40	(45)	-	-	(40)	-	(50)
. Petrol	30	25	(20)	(10)	(10)	(15)	(20)	(20)
. Other	90	85	(82)	(20)	(8)	(65)	(20)	(130)
Cash	37	40	7	-	30	40	30	40
Debt Relief 1/	152	67		-	152	67	152	67
Total	580	474						

Memorandum Items :

1987 Debt Service owed Including AMF/IMF 2/	157
of which :	
. Principal	(109)
. Interest charges	(48)
Arrears as of end 1986	172
Debt service before rescheduling as percent of (exports and private remittances)	110%

1/ Maximum eligible gross debt relief of $ 157 million (arrears $85 million + current debt service $72 million) less 5% repayable and moratorium interest payments ($3 million) on arrears at 4 percent per annum.

2/ Excluding frozen debts owed to Abu Dhabi, Bulgaria, China and USSR

FROM INFORMATION PROVIDED AT 1987 CONSULTATIVE GROUP MEETING foreign exchange remaining for paying non-reschedulable debt in 1987. Since the IMF originally ignored these arrears in calculating the 1987 gap, they also increase the gap for 1987 above the figure in Table 3A.

Based on Table 3B, provided at the CG, the financing gap before pledging was $580 million, which could be met through a combination of donor loans and grants and debt rescheduling/foregiveness. In determining debt relief, the amount "anticipated" again included virtually all reschedulable debt. With respect to donor pledges, it is essential that non-cash pledges be for commodities needed. Prior to the CG pledging, the combination of aid disbursements and debt relief required was estimated as follows (as shown in Table 9):

Project Aid	$226 Million
Commodity Aid	$165 Million
Of which Food	(45 Million)
Petrol	(30 Million)
Other	(90 Million)
Cash	$ 37 Million
Debt Relief	$152 Million
TOTAL	$580 Million

Although Somalia will necessarily default on large amounts of debt if there is no rescheduling and present debt problems, such as the arrears to the IMF, are hindering the recovery program, the debt problems are partially a matter of timing. When the export season begins around August, the GSDR will begin receiving approximately 60% of the total year's export proceeds in about a three month period. At a minimum, the GSDR will retain 50 percent of the total export proceeds. This is not enough to pay all debts due and still fund public sector imports, but with debt rescheduling and donor commodity assistance, it allows the public sector added flexibility. Unfortunately, there are critical debts due now.

-- (c). Donor Pledges: At the CG meeting, donors pledged aid in several categories. These were listed under the headings of (a) Project (essentially the Public Investment Program or PIP); (b) food aid; (c) petroleum; (d) other; and (e) cash. The "Cash" column includes only untied cash to the public sector. Consequently, cash programmed for the cash-auction system appears under the "Other" column.

Table 10 lists expected disbursement by donor, by category for both 1987 and 1988. The "totals" pledged versus required are as follows:

	Project	Food	Petrol	Other	Cash	TOTAL
Pledged	$373 M	$30 M	$20 M	$91 M	$ 0	$514 M
Required	$226 M	$45 M	$30 M	$90 M	$37 M	$428 M
GAP	+147 M	+15 M	-10 M	+1 M	-37 M	+ 86 M

TABLE 10

MEETING OF THE CONSULTATIVE GROUP FOR SOMALIA - APRIL 6 and 7, 1987

	1987 Expected / Pledged Disbursements (US $ million)						1988 Expected / Pledged Disbursements (US $ million)					
	Project	Food	Petrol	Other	Cash	Total	Project	Food	Petrol	Other	Cash	Total
U.S.A.	34	11		27			33	12		22		
Italy	200	5	7	20			120	5	5	30		
Germany	28	-	-	8			-	-	-	-		
Japan	8	-	-	-			5	-	-	-		
U.K.	2	-	-	6			-	-	-	-		
Finland	9	-	-	-			8	-	-	-		
France	13	-	-	-			8	-	-	-		
EEC	28	3	-	-			40	-	-	-		
IDA	18	-	13	30			25	-	10	28		
WFP	-	11	-	-			-	11	-	-		
IDB	17	-	-	-			4	-	-	-		
Arab Fund	-	-	-	-			5	-	-	-		
Kuwait Fund	-	-	-	-			1	-	-	-		
Saudi Fund	5	-	-	-			2	-	-	-		
IFAD	4	-	-	-			5	-	-	-		
ADB/ADF	7	-	-	-			4	-	-	10		
Pledged	373	30	20	91	0	514	260	28	15	90	0	393
Required	226	45	30	90	37	428	217	40	25	85	40	407

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Although the total pledges exceeded the required amount by $86 Million, these pledges will not help fill the gap. In particular, the $147 excess pledging for project aid will provide little if any help toward meeting other needs and will either result in a PIP larger than desired or a growing pipeline.

Some other categories are more fungible. Since the Central Bank will be providing a portion of export proceeds to the cash auctions, funds in the "other" category programmed for the cash auction can potentially release GSDR funds from the auction to public sector cash needs. If petroleum importation were transferred to the private sector -- which it will not -- it could also be funded through the cash auction. With regard to the food category, we understand the "required" amount was over-estimated to ensure sufficient food in case of a drought. It appears the need for this food is arising. It is important to note, however, that the table already includes unanticipated, emergency food needs. Certainly, the public sector does not have sufficient cash to meet its needs, but cash given to the auction <u>does</u> release export proceeds for the public sector, reducing its gap.

-- (d). <u>Public Versus Private Sector Needs</u>:

-- (1) Total Financing Needs: As indicated above and shown in Table 3B the latest estimate of total financing reqirements for Somalia for 1987 is $580 million of combined public and private sector needs as well as debt rescheduling. Public sector needs decrease by the exact amount of debt rescheduling. Potentially reschedulable debt already paid, however, increases the financing gap. For other categories, barring payments for embassies abroad and the GSDR imposed practical barrier to private sector petroleum importation, assistance can go to the public or private sector.

-- (2) Public Sector Requirements: Given Somalia's large debt and debt service payments, in addition to the $50 million total required for petroleum purchases and the funding needed to maintain embassies abroad, public sector requirements cannot truly be met with any realistic level of donor aid and debt rescheduling, and debt rescheduling only postpones the problems of debt further into the future as can be seen by Graph 3 and Table 1. The IMF analysis of financing requirements for 1987 (and 1988) is based on the amount and type of imports and the debt rescheduling necessary to meet program targets such as growth and inflation. Although figures are fungible, such factors as imports are estimated based on the required amount necessary to sustain a desired level of growth. The same is true for debt repayment, a build-up of cash reserves, and other variables. Many of these are, in themselves, targets. Attainment of exports at the level projected is critical for meeting goals, including imports which must generally decline if exports receipts are lower than projected. Donor assistance and debt rescheduling are also critical given their role in setting initial targets for growth and inflation. When projected levels are not met, accumulation of arrears is usually the major factor in achieving balance in the balance of payments. Arrears, which were already sizable, accumulated by $80 million in 1986. The IMF target for 1987 is a reduction in arrears of $112 million.

Given the mismatch of donor pledges and required categories, Somalia may very likely not receive sufficient donor support to meet all public sector requirements. Indeed, meeting these requirements is virtually impossible. At present, donor assistance in providing petroleum or funding of petroleum will only meet $20 million of the $50 million need. No donor funding for embassies has been pledged, and no cash, per se, was pledged. Multilateral debt cannot be rescheduled, and according to information provided by the World Bank at the Consultative Group meeting in April, 1987, the GSDR was $29 million in arrears to multilaterals at the end of 1987 and owes a total of $85 million during 1987. Debt rescheduling of bilateral debt may also be insufficient to make it possible to meet debt service obligations under any circumstances. With the exception of the immediate cash flow problem requiring funds to fund critical needs, including the IMF arrears and subsequent bridge loan, however, use of our ESF for the public sector rather than the cash auction will not alleviate public sector needs except at the direct expense of the cash auction.

According to the Agreement reached with the IMF and ratified by the Somali Council of Ministers, the Central Bank will receive all export proceeds, with the exporter reimbursed at the auction rate. The GSDR will place up to 50% of total export proceeds into the import auction. The remainder will go for "critical public sector needs," such as debt payment. Consequently, the GSDR and IMF can increase the amount of export proceeds retained by the GSDR by the amount that USAID places in the cash auction if the Fund and GSDR concur that the public sector has more need of these funds. Given the small size of our ESF program compared with export proceeds and the agreement that no more than 50 percent of export proceeds will go to the auction, there is no way we can truly augment public sector funds unless the GSDR and IMF decide that less than $16 million of export proceeds will go to the auction. The latter decision would jeapardize the auction and private sector activity.

-- (3) Private Sector Needs: The private sector needs foreign exchange for imports and service payments. The import needs of the private sector will need to be met by the expanded auction and donor CIPs. In the past two years, the GDR and World Bank have both had CIP (or Agricultural Input -AIP-) programs. During 1986, the World Bank funded approximately $10 million of Agriculturally related inputs. With the free market, however, CIPs and AIPs have become less attractive, and the auctions and free market have funded most imports. The FRG, however, is is essentially at the mid-point of a two-year program providing approximately $5 million to the private sector. The World Bank will provide about $10 in agriculturally related inputs in 1986-87 with its Agricultural Inputs Program II. Most imports, with the exception of the remaining GDR CIP funds and some remaining World Bank funds, will now

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be financed through the unified import auction. For the present, the IMF and GSDR anticipate meeting service payments through a separate auction of foreign exchange originating outside the country, e.g., remittances.

The IMF estimates that the import auction will require approximately $8.5 million monthly, or $102 for the year. During 1986, the private sector received approximately $50 million for imports from export proceeds alone. An additional, unknown amount was provided from external accounts. Although the donor cash auctions have not corresponded with the calendar year, in the eight and one half months of auctions since September 1, the United States, World Bank, and Italy have provided slightly over $40 million. Thus, the $8.5 million per month extimated by the IMF corresponds to approximately the total amount available for imports in 1986 from export proceeds plus an annualized calculation of donor-auction funding to date and a small amount provided through the external accounts. These funds will finance only imports. Services will be financed through another mechanism. Certainly, this amount is not excessive.

The World Bank AIP II program will be providing $25 million to the auction, with a potential five to ten million more provided through the Bank from the Japanese. USAID proposes to provide between $10 million and $12 million, depending on how much is needed for a critical debt payment immediately. Future, unified auctions will be run along the lines of the present donor auctions, though some decisions regarding private transactions need to be made.

Diplomatic missions will be expected to sell funds directly to the Central Bank- for its own use- at the auction rate. Until the May 17 auction, private companies and individuals could place money in the donor auction, and these funds supplemented, rather than replaced, donor funds. For the May 17 auction, private money offered to the auction was sold to the central bank at the auction rate. The disposition of such funds after the unified auction system begins has not been determined and will probably depend partially on public versus private sector needs. These funds are expected to become part of the agreed-on total, however. Since the volume for each auction is announced in advance, and for the unified auction will be determined well in advance, the disposition of private sector foreign exchange sales is not extremely germaine to the success or failure of the auction or public sector confidence in the system. There will be some impact on the private companies or individuals, who will receive the rate of the previous auction. By selling directly to the Central Bank, they have the advantage of knowing the applicable rate in advance.

Given the amount placed into the auctions in the past by private individuals and companies-- between $30 and $90 thousand per auction-- private sources will not help maintain a viable auction. If estimates of private sales through the auction raise the total amount above the $102 million the Fund has estimated as required, the GSDR can place a smaller percentage of export proceeds into the auction and have more left for critical public sector needs.

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-- (e) General Need For Cash Aid to Somalia, especially the Auction: Both the public and the private sectors have a large need for cash and commodity assistance. These needs, however, cannot be based simply on wants, which are unlimited. Regarding the private sector, for instance, the GSDR believes that donors should provide as much cash to donor auctions as is requested, which would have required $8.9 million last auction. Officials apparently have no concept of "effective demand," and totally ignore the fact that if the total volume requested is supplied, even if possible, the rate will drop drastically: to SoSh 1 = $1 for the April 1 auction, which was the lowest bid. (The next lowest was SoSh 100.). The result, even for recent auctions where the lowest bid has been around SoSh 100 = $1 will simply be a large increase in the volume requested in the next auction.

-- (f) Conclusion: Despite the enormity of the balance of payments deficit, the economy has responded positively to the policy reforms of the past several years. Agricultural production has increased. Inflation is considerably lower than the over 90% level of 1984 (down to 30 to 35%). The country has found new outlets for livestock exports despite the continued Saudi ban; this is due in part to the beneficial impact of devaluation and the free market. Even tax collections have increased. The impact on the overall balance of payments is neglible, however, because of the enormous debt (larger than GDP), the resulting unmanageable debt service payments, and large trade imbalance. Somalia requires large amounts of donor assistance, continued reform and structural adjustment, and several years before improvement is readily noticeable.

C. General Economic Conditions:

-1. Inflation: Inflation has been approximately 35% for each of the last two years. While this is a tremendous improvement over the almost 100% level of 1984, the rate is considerably higher than the 22% anticipated by the IMF when 1986 began. (See Table 11 for the Mogadishu CPI for 1985 to the present.) The Mogadishu consumer price index was 30% higher inDecember 1986 than in December 1985. The monthly average for 1986 was 35%. In July, 1986, when it was apparent that yearly inflation would be greater than anticipated, the IMF urged adoption of measures designed to lessen inflation. Interest rates had initially been set at 22%-- the anticipated inflation rate. They were raised, though not to a level equalling anticipated or actual inflation. Limits on net credit to the public sector were made more stringent. The GSDR accepted a Fund suggested ceiling on spending of donor-generated local currency. Inflation the first four months of 1987 has been 19%. (It was 20% for the same period in 1986 and 17.9 for 1985.)

While we share the Fund and Central Bank concern over the rate of inflation, we consider general monetary controls to be the province of

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Table 11: MOGADISHU CONSUMER PRICE INDEX BY MONTH, DECEMBER 1984 - APRIL 1987

	General CPI	Monthly Percentage Increase	Year to Date Increase	Food	Monthly Percentage Increase	Year to Date Increase
	96.48			96.11		
Jan 1985	100.00	3.65%	3.65%	100.00	4.05%	4.05%
Feb	101.07	1.07%	4.76%	100.05	0.05%	4.09%
Mar	107.83	6.70%	11.77%	104.00	3.95%	8.21%
Apr	113.77	5.50%	17.93%	109.03	4.84%	13.44%
May	124.05	9.04%	28.58%	121.80	11.71%	26.73%
June	123.01	-0.84%	27.50%	118.21	-2.95%	22.99%
July	123.93	0.75%	28.45%	119.58	1.16%	24.41%
Aug	117.68	-5.04%	21.98%	106.38	-11.03%	10.69%
Sept	115.89	-1.52%	20.12%	99.61	-6.36%	3.64%
Oct	123.20	6.30%	27.70%	104.29	4.69%	8.51%
Nov	123.34	0.12%	27.85%	103.85	-0.42%	8.05%
Dec	125.85	2.03%	30.45%	107.72	3.72%	12.07%
Jan 1986	131.84	4.76%	4.76%	113.74	5.59%	5.59%
Feb	137.82	4.53%	9.51%	118.71	4.37%	10.21%
Mar	144.07	4.54%	14.48%	122.55	3.23%	13.77%
Apr	150.98	4.80%	19.97%	131.48	7.28%	22.06%
May	163.42	8.24%	29.85%	140.70	7.01%	30.62%
June	168.11	2.87%	33.58%	145.43	3.36%	35.01%
July	172.02	2.33%	36.69%	143.41	-1.38%	33.14%
Aug	167.38	-2.70%	33.00%	137.18	-4.35%	27.35%
Sept	170.13	1.65%	35.19%	142.14	3.62%	31.96%
Oct	169.14	-0.58%	34.40%	139.16	-2.10%	29.19%
Nov	160.88	-4.88%	27.84%	129.03	-7.28%	19.79%
Dec	164.50	2.24%	30.71%	134.30	4.08%	24.68%
Jan 1987	174.27	5.94%	5.94%	146.46	9.06%	9.06%
Feb	173.86	-0.24%	5.69%	145.11	-0.92%	8.05%
Mar	183.37	5.47%	11.48%	156.51	7.85%	16.54%
Apr	196.31	7.06%	19.34%	177.42	13.36%	32.11%

Source: Ministry of National Planning

the IMF. We do want to ensure, however, that our ESF Program does not contribute to inflation. Any foreign exchange provided the private sector through auction will be used to purchase imports and the successful auction bidders will deposit Somali shillings converted at the auction rate into the special account. These shillings will be jointly programmed by the GSDR and USAID through procedures specified in the PAAD. Local currency will be used for funding development projects, paying external debt, and providing general budgetary support in areas where the GSDR is willing to implement reforms. Local currency for development projects will continue to be monitored by the Domestic Development Department of the Ministry of Finance. If total GSDR spending of donor-generated shillings becomes a great problem, the auction-generated shillings may also fall under the total spending limit imposed by the IMF on donor-generated local currency. Thus, the Foreign Exchange Market Support Program will not contribute to inflation and may, in fact have a deflationary impact if some of the generated shillings are not spent. In addition, the Procedures for jointly programming generated shillings results in spending that tends to be more beneficial to the economy.

-2. Public Finance:

-- (a). Background: The public finance area, including taxation and budgeting, is extremely important to USAID because of its link to civil service reform and because of a redirection of priorities toward improving public sector efficiency. The FY87 Program contains Covenants in the areas of budgeting and tax reform, and we have and will have several projects aimed at these areas. In addition, without an improvement in public sector budgeting, tax reform, and a decline in the domestic deficit, general stabilization efforts will not be successful.

Although the situation has improved moderately since 1984, domestic revenues remain grossly inadequate to finance recurrent government expenditures. Total government expenditure was 17.3 percent of GDP in 1986 according to IMF projections, and 11 percent according to the February, 1987 World Bank Report. This level is not high even for developing countries. Revenues, however, were only 5.6 percent of GDP, which is extremely low by third world standards. Not including grants, this left a fiscal deficit of 12 percent of GDP, based on IMF expenditure figures. In recent years, the difference between the GSDR's own revenue sources and expenditures has increasingly been financed through donor loans and grants, some of them as commodities. The Public Investment Program (PIP) is essentially funded entirely through donor loans and grants.

-- (b) Taxes and Other Non-Grant Revenues: Taxes are by far the major portion of "General Revenues," providing between 85% and 90% of total non-grant revenues each year. Tax collections in shilling terms increased dramatically in 1986, following attempts by the Minister of

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Revenue to improve tax administration, use of a higher rate for converting dollars to shillings, and a greater use of ad valorem rather than specific valuation for customs purposes. Somalia still relies much more heavily on customs related taxes (over 50% of total taxes) and customs, excises and sales taxes combined (approximately 90% of total tax revenues) than other LDCs.

Following is information on tax revenues provided in the August, 1986, IMF report. For 1985 and 1986, two sets of figures are provided: the first gives the value projected by the IMF when setting program targets at the beginning of the year. The second for 1985 is the preliminary calculation of actual collections. For 1986, the second column is the revised projections for the year, based on information gathered in the July, 1986, IMF visit to Somalia. The first is the Program Estimate after initial revision in the spring of 1986. As can be seen, the IMF was considerably more optimistic concerning 1985 tax increases when originally estimating the levels than actually happened. The Fund had expected large increases in customs revenues due to devaluation and the opening of the free market and instead had an increase in tax evasion. The Fund also estimated an increase in export duties, despite the deleterious impact of such taxes on exports and the balance of payments.

Tax Revenues
(in millions of Somali Shillings and as % of Total Tax Revenue))

	---1984---		---1985---		---1985---		---1986---		---1986---	
	Prel.Est.		IMF Prog.		Prel. Act.		Rev.Prog.		Est. 7/86	
Import Duty	1,816	60%	4,893	71%	2,551	56%	5,350	72%	4,350	58%
Export Duty	37	1%	250	4%	89	2%	150	2%	150	2%
Other Taxes	1,126	38%	1,727	25%	1,937	42%	1,900	26%	3,040	40%
TOTAL TAX	2,979		6,870		4,577		7,400		7,540	
Tot. Revenue	3,774		7,574		5,220		8,300		8,600	
Rev.as % GDP	4.9%		7.7%		4.5%		5.7%		5.3%	

Assuming the July estimates for 1986 are even close to accurate, what is especially noteworthy for 1985 and 1986 is the decreased reliance on import duties and the great increase in "other taxes," which includes income, excise, and sales taxes. The World Bank provides tax data through 1985 that is considerably more disaggregated. The numbers are similar and can therefore be used to indicate which "other taxes" increased. For 1985, the increased reliance on "other" taxes is due solely to an increase in collections from excise and sales taxes. Although the shilling value of income taxes increased very slightly in absolute terms, it decreased as a percentage of total tax revenues. These trends are probably also true for 1986.

-- (c). Reliance on Donors For Financing:

The importance of grants, including grants in-kind, has increased greatly since 1982, when grants provided only 28% of total revenue and grants. Grants now account for over 50% of this amount, and the percentage may be greater since some donor-generated local currency does not appear in the budget or appears under "other Revenue" sources. Sales of donor foreign exchange to the Central Bank, as well as commodities and/or cash to the public and private sectors, are the mechanisms for generating financial support for the national budget.

Grant And General Revenues
(in millions of SoSh and as % of Total Revenue and Grant Funding)

	--1982--		--1983--		--1984-- Prel.est.		--1985-- Pre.Act.		--1986-- Proj.7/86	
Grants	1,056	28%	1,106	21%	1,980	33%	6,620	56%	10,453	55%
Collected Revenue (Tax and non-tax)	2,588	68%	4,075	76%	3,774	63%	5,220	44%	8,600	45%
Transfers From Local Auth.	172	4%	178	3%	205	3%	---		---	
TOTAL REVENUE AND GRANTS	3,816		5,359		5,959		11,840		19,053	

A large percentage of the budget deficit is also financed by donors, generally at concessionary rates. Loans frequently come from donor-generated local currency. The following table shows the financing of the GSDR domestic-budget deficit:

Financing of Domestic-Budget Deficit
(in millions of SoSh and as % of Total Revenue and Grant Funding)

	--1982--		--1983--		--1984-- Prel.est.		--1985-- Pre.Act.		--1986-- Proj.7/86	
Foreign (net)	1,727	111%	1,572	123%	940	27%	5,033	70%	7,091	67%
Domestic	-174		-295		2,565	73%	1,045	15%	-61	-1%
Banking system (net)	(-150)		(-295)		(2,573)		(875)		(-61)	
Cash Balances	(-24)		(--)		(-8)		(170)		(--)	
Debt Relief	--		--		--		1,080	15%	--	
Financing Gap	--		--		--		--		3,631	34%
Overall Deficit on Cash Basis	1,550		1,277		3,505		7,158		10,661	

-- (d). Impact of Donor Financing on the Economy: The large amount of donor-generated shillings at the disposal of the Ministry of Finance has a potentially inflationary impact since many of the shillings come from sales of foreign exchange to the public sector and essentially represent money creation, not a corresponding removal of shillings from the private sector, either through sale to the private sector or taxes. The shillings also increase the GSDR's ability to increase spending above limits imposed by the IMF. It is for these reasons that the IMF has imposed limits in mid-July, 1986, on the total amount of donor-generated local currency which may be spent by the Ministry of Finance and might continue to do so.

In addition to this impact on the economy via the money supply, the on-going ability of the GSDR to tap into donor-generated shillings encourages the government to fund development activities beyond its own means and increases GSDR dependency upon donors for ordinary budget support as well as for foreign exchange needs. Furthermore, there is no sign of consideration being given to the need to eventually assume the costs associated with development projects when donor funding ceases.

— (e). Expenditures -- General Budgeting: At the national level, budgets are disaggregated into Ordinary and Investment expenditures. The distinction is highly superficial given the wide-spread tendency to incorporate ordinary, recurrent expenditures into the investment or development budget. For example, frequently any person associated with a development project has his/her salary provided for in the investment (development) budget, even though the Government has every intention of retaining the person on its payroll after the project ends.

Considering this, the expenditure information which follows should be viewed with care.

Domestic Expenditures
(in millions of SoSh and as % of Total Revenue and Grant Funding)

	--1982--	--1983--	--1984-- Prel.est.	--1985-- Pre.Act.	--1986-- Proj.7/86
Ordinary Expend.	2,750 51%	4,539 68%	7,964 71%	9,918 56%	11,854 42%
Wages & Salaries	(--)	(--)	(2,152)	(2,152)	(2,200)
Interest: Domestic	(--)	(--)	(485)	(486)	(600)
Foreign	(--)	(--)	(540)	(1,167)	(2,180)
Other Expenditure	(--)	(--)	(4,890)	(6,133)	(6,874)
Investment expend.	2,461 46%	1,920 29%	3,124 28%	7,940 44%	16,460 58%
Development budget	(348)	(498)	(604)	(1,372)	(2,610)
Transfer to Local Authorities	155 3%	177 3%	175 1%	—	—
TOTAL EXPENDITURES	5,366	6,636	11,264	17,858	28,314

(Numbers do not always all because of rounding)

	--1982--	--1983--	--1984--	--1985--	--1986--
EXPENDITURES AS % OF GDP					
TOTAL	19.2%	17.0%	14.7%	15.4%	17.3%
Ordinary Exp.	(9.8%)	(11.6%)	(10.4%)	(8.5%)	(7.3%)
Investment Exp.	(8.8%)	(4.9%)	(4.1%)	(6.8)	(10.1%)
(Dev. Budget)	(1.2%)	(1.3%)	(0.8%)	(1.2)	(1.6%)

Expenditures as a percentage of GDP have not changed greatly during the decade although revenues, as a percentage of GDP, dropped from 9.3% in 1982 to a projected 5.3% for 1986. The GSDR has been able to maintain the expenditure level only by increasing reliance on donor grands and deficit spending, including loans from goverments.

-- (f) General Budget Situation: There would appear to be a change in the relative importance of the budget aggregates. However, the shift toward investment expenditures away fron ordinary expenditures is more apparent than real and should not be interpreted as a shift in GSDR priorities or an indication that changes in true priorities were even responsible for the change. This results from the failure to distinguish carefully between recurrent and capital costs and the application of budget categories with little functional meaning. There is clearly a need to redefine accounting/budgeting terminology.

Finally, it should be pointed out that no attempt has been made to coordinate the medium- and long-term planning efforts of the Ministry of Planning, as reflected in the Public Investment Program (PIP), with the decisions of the Ministry of Finance regarding short-term resource allocation and the Ministry of Revenue regarding available tax financing. Furthermore, neither the Ministry of Planning nor the Ministry of Finance is able to make decisions based upon reliable projections regarding revenue availability.

In addition, the public sector is relying increasingly on donor-generated local currency to fund all portions of the budget. In the short run, this local currency is needed for funding general operating expenses. In the long run, it is creating a dependency on donors for both foreign exchange and the domestic public sector. Even after the large increase in tax collections in 1986, the revenue/GDP ratio is expected to increase to only 5.3 percent. This is due in large measure to the lack of revenue elasticity of the tax base and the increased tax evasion accompanying devaluation and the sudden, shart increase in the shilling value of import duties. If the Minister of Revenue is allowed to continue with his reforms, the tax revenue picture should improve in the next few years.

-- (g). Relationship to USAID ESF: Of more concern now is the general lack of budgeting and the increasing reliance on donor-generated local currency for funding. Certainly, our ESF Program generates a considerable amount of local currency and potentially adds to the GSDR reliance on donors for funding the domestic budget. At the same time, and unlike the local currency of other donors, U.S. generated local currency is jointly programmed. Therefore there are more safe-guards for ensuring it goes for more development-related expenditures or for debt repayment needed to maintain the country's creditworthiness and to ensure donor funding continues.

Nevertheless, we believe the GSDR needs to gain more control over the budgeting process and plan for an orderly transition from reliance on donor-generated local currency to use of tax and other non-donor related sources. Since the ESF program will provide substantial local currency, we will include conditionality in the program requiring the GSDR to accept a high-level advisory team to examine the budgeting process. We are also addressing the general management problems related to budgeting, revenue enhancement, and reliance on donor funding through SOMTAD advisors to the Ministries of Revenue, Finance, and Planning and through the USAID financial advisor to the Ministry of Finance. Additional support through the Policy Initiatives and Privatization Project is also available if needed.

-3. Investment: Recent monetary developments reflect the reduced fiscal deficit and the higher level of foreign financing, as the expansion of recorded domestic credit slowed from 82 percent in 1984 to about 18 percent in 1985. Credit restrictions on both the private and public sectors are integral and important parts of the IMF program. Increases in interest rates have also been an important component of IMF negotiations and Programs, as can be seen by Table 9, Indeed, when setting targets at the beginning of 1986, interest rates were set to equal the anticipated level of inflation, though real interest rates continued to remain negative because of higher than anticipated inflation.

The broad money supply still increased sharply in 1985 due to the increase in foreign currency deposits by the private sector and their rising value in shilling terms given the depreciation of the shilling, and to the build-up of counterpart funds from commodity assistance programs. Nevertheless, the rate of inflation for 1985 and 1986 remained just over one-third the high level of 1984.

Gross domestic investment in recent years has been maintained at around 15 percent of GDP, while gross domestic savings remained negative. The level of fixed investment increased from around 9 percent of GDP in the early 1980's to about 14 percent in 1984 and 1985. Changes in stock (the difference between total and fixed investment) in Somalia represented just that literally, mainly drought induced changes in privately-owned livestock. The volume is volatile. Around 80 percent of the estimated domestic fixed investment has been undertaken by the public sector. Of this, about a third has been in the agricultural sector, another third for economic infrastructure (energy, water, transport, and communications) and an increasing share (from six percent in 1980-81 to 14 percent in 1984-85) for education and health. Public investment strategy in the 1980's has shifted from the large investments in public enterprises of the 1970's to an emphasis on the rehabilitation and development of infrastructure and services to support the private sector as the main source of productive growth. Private fixed investment is primarily in livestock and crop production, small-scale manufacturing, retail trade, road transport, and residential construction. Private fixed investment has increased as a share of the total from around 15 percent in the mid 1970's to over 20 percent in 1985.

D. Foreign Exchange Regime

As in FY86, we propose to use FY87 ESF funds to encourage and support a market-determined foreign exchange regime. To understand the proposed program, therefore, it is necessary to understand the present foreign exchange regime and the changes that are likely to occur with unification.

-1. Present Foreign Exchange System: Somalia presently has two exchange rates: the official rate which is SoSh 1 = $.011 (SoSh 90 = $1) and a free market "rate." There was a third rate-- the Commercial Bank rate-- until it was unified with the official rate in October, 1986. Under the original 1985 Standby, the GSDR was supposed to unify the official, commercial bank and free market exchange rates during 1985. Small devaluations of the official rate were to be made every month until July, at which time the GSDR was to submit a plan for unification, with a schedule for devaluation. The Government ceased devaluing and failed to devise a plan for unification. Thus, unification formed a major part of the 1985 Extension. Under the extension, which expired September 30, 1986, Somalia was supposed to unify the free market and official rates by the end of 1986. To help accomplish this, the GSDR was supposed to devalue the official rate by SoSh 12 per dollar in January, 1986, followed by devaluations of SoSh 4 per dollar each month until unification.

The last devaluation was November 1, 1986, bringing the official rate to SoSh 1 = $.0111, and making the total devaluation for the year 53%. (The shilling started 1986 at a rate of SoSh 1 = $.0238 (SoSh 42 = $1). The GSDR did not devalue in December, 1986, anticipating unification. They appear to want to have begun at SoSh 90 rather than SoSh 1 = ($.0106 (SoSh 94) in bargaining with the IMF on an acceptable rate for unification. As a result, the gap between the official and free market rates stopped narrowing. (Table 12 shows the ratio of the official rate to the free market rate since opening of the free market.)

At the beginning of 1986, there was a third rate: the commercial bank rate. This was the rate one received by changing foreign exchange directly with the commercial bank instead of opening an external account and using the free market. In October, 1986, the official rate surpassed the commercial bank rate, and the two are now equal. Anyone changing foreign exchange directly with the Commercial Bank, rather than opening a foreign exchange account and using the free market, now receives the official rate of SoSh 90 = $1. (Table 13 and Graph 4 show changes in the official, commercial bank, and free market rates since the free market was opened.)

Table 12: OFFICIAL RATE AS PERCENTAGE OF FREE MARKET RATE

Month	1985	1986	1987
January	41%	37%	60%
February	41	44	59
March	41	42	59
April	40	42	57
May	40	43	
June	41	45	
July	40	48	
August	40	57	
September	40	59	
October	37	61	
November	37	63	
December	37	63	

Table 13 CHANGES IN OFFICIAL, COMMERCIAL, AND FREE MARKET EXCHANGE RATES

(January 1985 through April, 1987) Somali Shillings Per U. S. Dollar

	Official Rate (1) (on Fifteenth Day of Month)		Commercial Bank Rate (1) (on Fifteenth Day of Month)		Free Market Rate (Average for Month)	
	SoSh/$	$/SoSh	SoSh/$	$/SoSh	$/SoSh	SoSh/$
January 1985	35.6400	0.028058	76.480	0.013075	88.26	0.011330
February	36.1350	0.027674	79.550	0.012571	88.48	0.011302
March	37.6300	0.026575	80.350	0.012446	91.56	0.010922
April	37.1250	0.026936	80.350	0.012446	92.83	0.010772
May	37.1250	0.026936	81.920	0.012207	93.86	0.010654
June	39.7020	0.025188	83.600	0.011962	97.63	0.010243
July	40.2022	0.024874	83.600	0.011962	101.46	0.009856
August	40.2022	0.024874	83.600	0.011962	102.09	0.009795
September	40.2022	0.024874	83.600	0.011962	100.31	0.009969
October	40.2022	0.024874	83.600	0.011962	107.43	0.009308
November	40.2022	0.024874	83.600	0.011962	109.83	0.009105
December	42.0750	0.023767	83.600	0.011962	114.63	0.008724
January 1986	42.0750	0.023767	83.600	0.011962	114.76	0.008714
February	53.9550	0.018534	83.600	0.011962	122.90	0.008137
March	57.9150	0.017267	83.600	0.011962	138.63	0.007213
April	61.8750	0.016162	83.600	0.011962	148.96	0.006713
May	65.8350	0.015189	83.600	0.011962	152.56	0.006555
June	69.7950	0.014328	83.600	0.011962	155.21	0.006443
July (2)	73.7550	0.013558	83.600	0.011962	153.40	0.006519
August	77.7550	0.012861	83.600	0.011962	137.66	0.007264
September (3)	81.6750	0.012244	83.600	0.011962	138.98	0.007195
October (3)	85.6750	0.011672	85.675	0.011672	141.46	0.007069
November (3)	89.5650	0.011165	89.565	0.011165	139.96	0.007145
December (3)	89.5650	0.011165	89.565	0.011165	142.48	0.007019
January 1987 (3)	89.5650	0.011165	89.565	0.011165	149.36	0.006695
February (3)	89.5650	0.011165	89.565	0.011165	150.76	0.006633
March (3)	89.5650	0.011165	89.565	0.011165	153.48	0.006516
April (3)	89.5650	0.011165	89.565	0.011165	157.60	0.006345

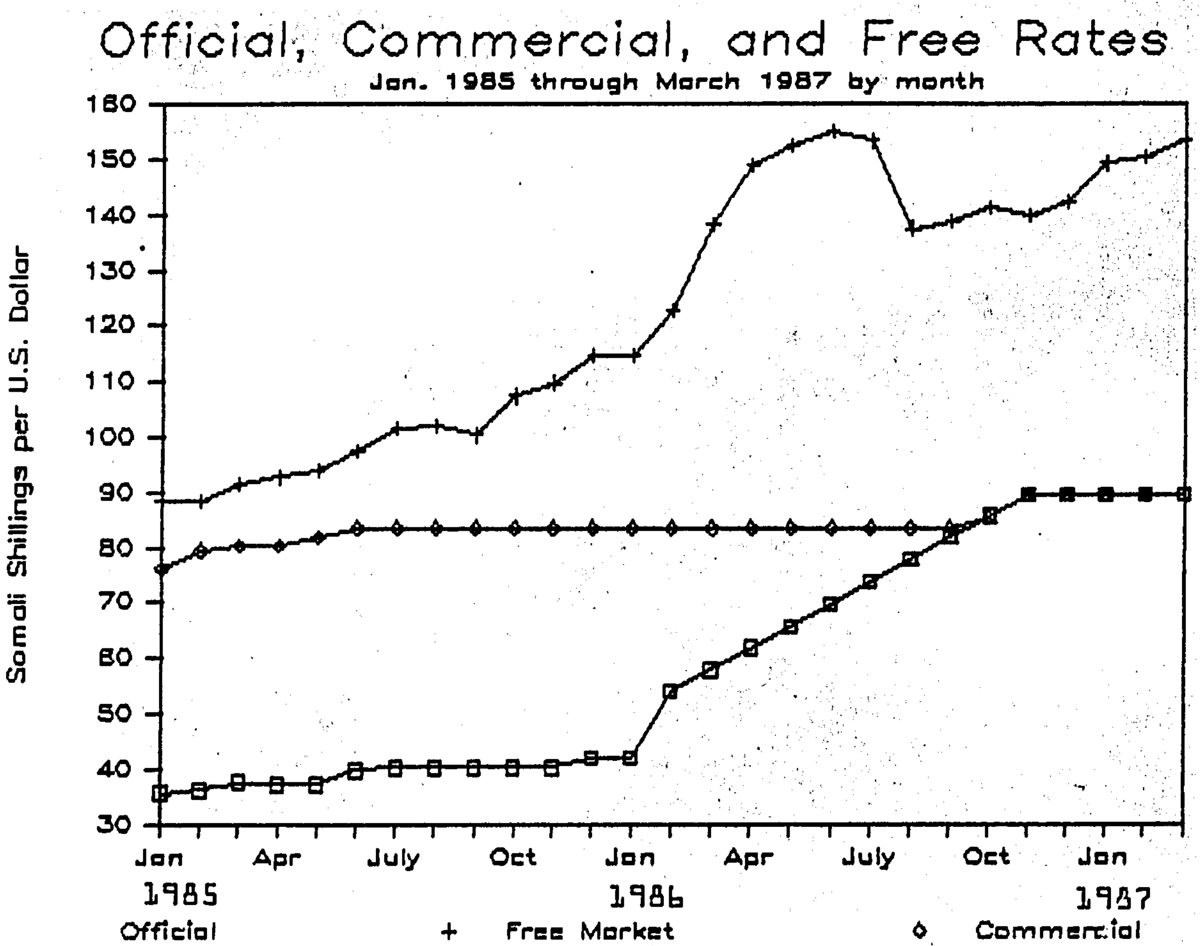
(1) The Official and Commercial Bank Rates are the rates applicable for selling dollars

(2) The free market rate for July excludes the two transactions between government agencies at a fixed rate of SoSh 100 = $1.

(3) The free market rates for September and October, 1986, exclude transactions that occurred at exactly SoSh 100 = $1. For November, 1986 through April, 1987, the free market rate excludes transactions at more than 20 shillings below the daily or weekly average for that type of account. For February, 1987, this resulted in dropping one EPA transaction at SoSh 100 = $1. (There were two other anomolous transactions at approx. 20 shillings below the average, but they had little impact on the overall rate and were included For March, there were two transactions at approx. SoSh 15 for that type of account which were included.

Sources: Commercial and Savings Bank of Somalia and Central Bank of Somalia

GRAPH 4



SOURCES: CENTRAL BANK OF SOMALIA AND COMMERCIAL AND SAVINGS BANK OF SOMALIA

A further description of the official and commercial bank rates follows:

--Official Rate: This rate began at SoSh 1 = $ .0238 (SoSh 42 = $1) in January, 1986. It was used primarily for Government to Government transactions. The sources of official foreign exchange were primarily the 50% of export proceeds which needed to be surrendered to the Central Bank at the official rate and donor grants and loans. The major expenditures of official foreign exchange were debt repayment, payment for GSDR embassies abroad, and GSDR petroleum purchases, though petroleum was supposed to be sold at a shilling rate made at a free market conversion.

--Commercial Bank Rate: This rate was established in January, 1985, as the rate which was supposed to float, at least weekly. As can be seen from Column 2, Table 6, and Graph 4, the rate never changed mucn, and it almost immediately became over-valued. In October, 1986, the official rate surpassed the commercial bank rate, and since that time, the official and commercial bank rate have been unified. The Commercial Bank Rate was used by anyone transacting business directly with the Commercial Bank, rather than opening a free market account and using it. There was very little foreign exchange available at this rate, though there are no even unreliable figures on the probable amount. It was virtually impossible for someone without political connections to go to the Commercial Bank and receive dollars by paying the Commercial Bank shilling rate. This is still true. The Commercial Bank buys dollars at the official/Commercial Bank rate of approximately SoSh 1 = $.0111 (SoSh 90) and in reality sells at around SoSH 1 = $.0083 (SoSh 120). During 1985 and early 1986, most CIPs used this rate. Although the German Democratic Republic indicated in September, 1986, it would use the donor auction rate for its new CIP, the Commercial Bank/Official rate was used.

-2. Free Market and Proposed Changes Under Unification: The free market is the one which has received the most attention since it is the primary mechanism through which the private sector obtains funds for importation, with the exception of the few remaining CIPs and the donor auctions which started in September, 1986. The free market rate has fluctuated considerably; because of the free market, exporters have been able to obtain a greater return without smuggling. The donor-auction system was started to supplement and stabilize the free market. In the free market, individual buyers and sellers negotiate the rate for each transaction. Thus, transactions each day take place at a variety of different rates. With few exceptions, however, the rates for the various transactions on any given day are extremely similar. There are three types of free market accounts:

External accounts: Foreign exchange for these must originate outside of Somalia, from remittances or accounts of expatriates. This is the only account from which funds can readily be transferred outside Somalia without restriction. Consequently, the average rate for external accounts generally exceeds that of the other two types of accounts. Anyone wishing to open an external account and possessing $1,000 which originated outside Somalia may do so.

Under the "unified system," the present proposal calls for maintaining external accounts under a modified arrangement. Persons holding external accounts will no longer be able to sell the foreign exchange directly to another individual at a mutually negotiated price. Rather, they may use the funds themselves or place the funds in an auction for financing external service payments. This auction is expected to be small. It is not the one USAID is funding. The mechanics of this auction have not been as clearly determined as those for import financing.

Both the GSDR and IMF presently believe the exchange rate in this limited auction will be higher than that for the import auction. A higher exchange rate is certainly desirable to encourage remittances, but without more information on potential supply and demand for in this auction, the relationship between its rate and that of the other cannot be determined. Other variables as yet unclear will also affect the relative rates of the two auctions. Responses from officials differ as to whether ex-patriates may auction through the "services" auction or must either use the other auction or sell directly to the banking system at the rate of the import auction. Additionally, some officials believe that importers will be free to bid in either auction. If the latter is true, the exchange-rate differential for the two auctions will narrow, and remittances will be more likely to be channeled through the black market.

Export Promotion Accounts: Funds in these accounts come from the 50 percent of export proceeds which may be retained by the exporter. (The other 50 percent goes to the Central Bank at the official rate.) With few exceptions, funds in Export Promotion accounts may only be used for sale or transfer into import accounts to be used to finance legitimate imports and services.

Following unification, all export receipts will be surrendered to the Central Bank at the previous import-auction rate. The impact of this change on the shilling return to exporters will depend on the difference between the auction rate and the average of the present official rate and free market rate for export promotion accounts. (Under-invoicing occurs at present to allow some export receipts to be transferred at the higher, external-account rate. This will likely continue.)

Import Accounts: Funds in these accounts come from sales from External Accounts and Export Promotion Accounts. Funds may be used only for sale into other import accounts or for financing legitimate imports and services.

Following unification, no new import accounts as they presently exist will be allowed. At present, funds may accumulate in these accounts indefinitely and/or be sold to other individuals. Neither of these actions will continue to be possible. Successful bidders in the import auction will have a limited time period in which to open an L/C for an eligible import. The funds cannot be sold to someone else, though the goods can certainly be imported-- unofficially-- for another individual.

At the present time, persons holding foreign exchange in any one of the three accounts may also sell funds to another account of the same kind. This will no longer be allowed following "unification." Thus, there will be no free market accounts which can be used for speculation.

The opening of the free market was a major step toward freeing the economy and helping the private sector. Prior to the opening of the free market, foreign exchange was controlled and allocated by the Government. The foreign exchange that was available through the banking sector was over-valued (inexpensive) but inadequate to meet demand. The only other recourses were purchases on the thriving black market in Jidda or under-invoicing or smuggling of exports, using the export receipts to finance imports. To encourage needed imports, in fact, the Government semi-legalized this through the Franco Valuta system whereby imports could be financed with an individual's "own" foreign exchange originating outside the country. Since the inception of the free market, it has provided unhindered access to foreign exchange by the private sector. The original donor auction mechanism was established as a method for channeling donor funds to the private sector in a market-determined manner and to stabilize the free market and make it more viable.

The free market is not without its detractors. Most Somalis would like foreign exchange at a cheaper rate, and many assume their own political connections would assure an adequate supply of foreign exchange under a fixed over-valued exchange regime. Nevertheless, these same persons are quite willing to pay whatever is the going rate on the free market when they have need of hard currency. Since the opening of the free market, complaints about inability to produce because of a lack of foreign exchange for raw materials or other inputs has all but ceased. (Lack of petroleum and electricity remain frequent problems, and some persons cannot produce profitably at the higher, unsubsidized exchange rate.)

The free market, however, has also given more correct pricing signals to exporters and importers. For the most part, imports are now arriving at market-determined, not subsidized, prices, giving more incentive to productive domestic industries and agriculture. In addition, even with the 50% export requirement at the official rate, exporters have been receiving a greater return.

-3. Reliability of Data Provided In Tables on the Free Market: The Commercial and Savings Bank provides information on all foreign exchange rates, including free market transactions. For the free market, they provide USAID with information which includes the number and volume of transactions and the exchange rate. The degree of information provided has increased since the free market first opened, and the information is helpful. Nevertheless, this information should be used with discretion since it does not always indicate what one might assume, and persons using these data should do so with care.

In 1985, the Commercial Bank only provided monthly totals, with information for the three accounts aggregated. Beginning in 1986, information has been provided on a daily basis, giving the aggregate number and volume of transactions for each type of account and one exchange rate for the day, which was a weighted average of all transactions. Beginning in mid-September, 1986, they began giving the volume and exchange rate for each transaction for each type of account, making it possible for the first time to see the variation among transaction rates each day and the differences between the exchange rate for the three types of accounts.

The information which is provided USAID lists activity according to the type of account from which the funds came. It does not indicate the account into which funds are transferred. In addition, the total volume does not list transfers from one account to another of the same individual, and certain other transactions probably go unrecorded. For 1985, the total dollar volume of transactions recorded on the lists provided USAID-- from all three accounte-- was approximately $44.9 million. (The IMF gives yet another figure.) Some of this amount represents re-sale of the same funds. The World Bank estimates the total volume of imports financed through free-market export proceeds in 1985 at $42.9 million for the year. Financing for free market imports would come from EPAs and External Accounts, though the latter also finances transfers of funds abroad for other purposes. Given the number of re-sales of the same funds recorded in free marekt data and the external account funds transferred abroad for purposes other than imports, the free market data we received did not include sufficient information to identify export or other funds available for imports.

For 1986, the total volume of sales recorded from EPAs on information provided USAID was only approximately $5 million. Total recorded exports were $98, however, and only one half this amount was sold to the Central Bank. The remainder of recorded exports should have filtered through EPAs. Separate information indicates that, indeed, approximately $50 million went into export accounts, the majority of which did finance imports.

Thus, the number of transactions and dollar volume in the attached tables should not be used to calculate the volume of funds available during the year or each month, the total volume of funds going into EPAs, total imports financed through the free market, or any other such use. Despite this, though, the recorded sales on the tables do peak during the export season and also tend to show increased volume during periods when other evidence indicates large use of the market for speculation.

The exchange rates provided by the Commercial and Savings Bank, however, appear to be fairly accurate. Persons will often record a slightly lower rate than actually negotiated, but in general, the declared rate is close to the actual rate. This information can be used with a good degree of accuracy to indicate daily and monthly changes in exchange rates of the various accounts.

-4. Free Market Activity in 1985, 1986, and 1987: The free market devalued sharply and suddenly the first 4 months of 1986. This contrasted with free market activity the first 4 months of 1985. When adjusted for inflation, the experience the two years was also different. This can be seen from Table 14 and Graph 5. In 1985, inflation proceeded at a faster pace than devaluation, thus indicating it may have been inflation which was helping fuel devaluation. In the beginning of 1986, devaluation proceeded at a faster rate than inflation. Discussions with Somalis also indicated they considered the free market a good source of quick income.

The free-market shilling devalued 19.5% against the dollar from December, 1985, to December 1986. When adjusted for inflation, the rate appreciated 5.2% over that time period. Activity during the 1986 varied greatly, however, as Tables 14 and 15 and Graph 5 illustrate. The rate devalued very suddenly the beginning of 1986. From January to April, 1986, (a four month period), the exchange rate devalued 22.96% as opposed to only 4.9% for the corresponding period in 1985. When adjusted for inflation, devaluation from January through April, 1986 was 11.8%. The previous year, the shilling adjusted for inflation actually appreciated 8.2% over that same period.

In 1986, the nominal (actual) rate continued to rise versus the dollar through June, dropped slightly in July and considerably more in August. For a short period in August, the average for all accounts dropped to around SoSh 1 = $.0082 (SoSh 122 = $1), resulting in a 27% appreciation from the June average. This large appreciation resulted from the announcement of the upcoming World Bank cash auction and the mistaken impression that $10 million might be offered each auction. When auctions began September 1, the rate depreciated somewhat and then remained quite stable throughout the remainder of 1986.

The IMF stabilization program called for an anticipated level of inflation for 1986 of 22%, as opposed to the 35% level of 1985, and the GSDR was adhering to much of the program despite the lapse in the 1985 stand-by. By early summer, it was apparent that inflation would be at least 30% for the year. Based on a monthly average, inflation was actually closer to 35% for 1986. Therefore, the large devaluation of the shilling on the free market during the first half of 1986 caused great consternation. While it is not completely possible to separate cause and effect, especially in Somalia where data are often non-existent or unreliable, it is probable that devaluation in 1985 resulted largely from the shilling adjusting for inflation, especially relative to Somalia's

Table 14: FREE FOREIGN EXCHANGE TRANSACTIONS, JANUARY 1985 - APRIL 1987

Month	Number of Transactions	Amount of Foreign Exchange ($ '000)	Average Size Of Transactions ($ '000)	Free Market Rate (Avg. for Month) (SoSh/US$)	Free Market Rate (Avg. for Month) (US$/SoSh)	Monthly Cost of Living Index	Average Real Exchange Rate (SoSh/US$)	Average Real Exchange Rate (US$/SoSh)
January 1985	229	973.3	4.25	88.26	0.01133	100.00	88.26	0.01133
February	229	2,070.9	9.04	88.48	0.01130	101.07	87.55	0.01142
March	309	2,319.3	7.51	91.56	0.01092	107.83	84.91	0.01178
April	374	2,718.9	7.27	92.83	0.01077	113.77	81.59	0.01226
May	358	4,594.3	12.83	93.86	0.01065	124.05	75.66	0.01322
June	286	2,930.2	10.25	97.63	0.01024	123.01	79.37	0.01260
July	374	2,922.7	7.81	101.46	0.00986	123.93	81.87	0.01221
August	151	4,673.6	30.95	102.09	0.00980	117.68	86.75	0.01153
September	178	8,969.2	50.39	100.31	0.00997	115.89	86.56	0.01155
October	165	4,315.4	26.15	107.43	0.00931	123.20	87.20	0.01147
November	157	2,915.1	18.57	109.83	0.00910	123.34	89.05	0.01123
December	282	5,385.1	19.10	114.63	0.00872	125.85	91.09	0.01098
January 1986	263	6,365.9	24.20	114.76	0.00871	131.84	87.05	0.01149
February	295	4,040.5	13.70	122.90	0.00814	137.82	89.18	0.01121
March	306	3,473.6	11.35	138.63	0.00721	144.07	96.22	0.01039
April	262	3,393.1	12.95	148.96	0.00671	150.98	98.66	0.01014
May	280	4,383.6	15.66	152.56	0.00655	163.42	93.36	0.01071
June	268	4,180.3	15.60	155.21	0.00644	168.11	92.33	0.01083
July (1)	435	5,339.4	12.27	153.40	0.00652	172.02	89.17	0.01121
August	271	3,420.7	12.62	137.66	0.00726	167.38	82.24	0.01216
September (2)	294	3,858.2	13.12	138.98	0.00720	170.13	81.69	0.01224
October (2)	272	3,873.0	14.24	141.46	0.00707	169.14	83.63	0.01196
November (2)	265	3,586.1	13.53	139.96	0.00714	160.88	86.99	0.01150
December (2) (3)	257	5,487.3	21.35	142.48	0.00702	164.50	86.62	0.01155
January 1987 (2)	245	3,632.2	14.83	149.36	0.00670	174.27	85.70	0.01167
February (2)	206	3,034.3	14.73	150.76	0.00663	173.86	86.71	0.01153
March (2)	294	5,226.4	17.78	153.48	0.00652	183.37	83.70	0.01195
April (2)	335	4,728.5	14.11	157.60	0.00635	196.31	80.28	0.01246

(1) The free market data for July excludes the two transactions between government agencies at a fixed rate of SoSh 100 = $1.

(2) The free market information for September and October excludes transactions at a rate of SoSh 100 = $1, since these are assumed to have taken place between Government Agencies at a non-negotiated rate. For November, 1986 through March, 1987, the free market rates for each day exclude transactions at more than 20 shillings below the daily or weekly average for that type of account. For January, 1987, two transactions at less than SoSh 130 were eliminated. Tl For February, one EPA transaction at SoSh 100 was eliminated. There were two other anomolous transactions (125 and 130). Although they were considerably below the daily averages of 145 to 155, their inclusion did not alter the averages significantly and they were left in. For March, there were two transactions, one each in External Accounts and EPAs, which were only 15 shillings below the average. Therefore, the March figures include all transactions.

(3) The volume for December is abnormally large because of one Export Promotion Account transaction on December 24 for $1,500,000. The total volume for EPAs for December was only $1,625,573. Such "abnormal" transactions usually involve parastatals or other Government agencies. If this transaction is omitted, the total volume for December becomes $3,987,300, which is in line with other months since August.

Sources: Somali Commercial and Savings Bank and Central Bank of Somalia

Table 15: FREE FOREIGN EXCHANGE MARKET BY ACCOUNT BY MONTH, JANUARY 1986 - APRIL 1987

	Import Account	Export Promotion Account	External Account	Total Volume	Total Number Transactions	Average Exchange Rate
Jan. 2-10 1986	$630,539	$269,506	$412,651	$1,312,696	65	114.91
11-20	$585,477	$922,942	$1,103,864	$2,612,283	95	111.80
21-31	$1,751,224	$109,533	$580,196	$2,440,953	103	117.57
Total January	$2,967,240	$1,301,981	$2,096,711	$6,365,932	263	114.76
Feb. 1-10	$594,998	$357,002	$834,781	$1,786,781	117	115.40
11-20	$251,500	$218,261	$692,808	$1,162,569	110	125.07
21-28	$543,000	$138,999	$409,172	$1,091,171	68	128.23
Total February	$1,389,498	$714,262	$1,936,761	$4,040,521	295	122.90
March 1-10	$615,850	$38,360	$572,415	$1,226,625	92	132.18
11-20	$406,074	$58,500	$764,596	$1,229,170	108	140.0
21-31	$147,600	$20,586	$849,646	$1,017,832	106	143.
Total March	$1,169,524	$117,446	$2,186,657	$3,473,627	306	138.
April 1-8	$247,200	$15,700	$541,155	$804,055	81	150.
9-20 *	$358,778	$338,700	$1,051,029	$1,748,507	102	145.
21-30	$118,400	$64,700	$657,440	$840,540	79	152.0
Total April	$724,378	$419,100	$2,249,624	$3,393,102	262	148.96
May 1-10	$238,335	$20,000	$704,067	$962,402	84	152.24
11-20	$40,528	$25,970	$1,147,810	$1,214,308	99	151.69
21-31	$616,965	$1,000	$1,588,936	$2,206,901	97	153.83
Total May	$895,828	$46,970	$3,440,813	$4,383,611	280	152.56
June 1-10	$48,998	$15,900	$1,551,116	$1,616,014	82	152.34
11-19	$568,250	$98,050	$1,001,915	$1,668,215	110	153.83
20-30	$143,844	$10,000	$742,261	$896,105	76	157.10
Total June	$761,092	$123,950	$3,295,292	$4,180,334	268	155.21
July 1-10	$341,495	$171,700	$1,034,600	$1,547,795	125	155.34
12-20 **	$1,264,740	$0	$884,467	$2,149,207	142	153.00
21-31 **	$133,050	$7,200	$1,102,146	$1,242,396	166	152.00
Total July	$1,739,285	$178,900	$3,021,213	$4,939,398	433	153.40
August 1-10	$152,790	$10,000	$880,553	$1,043,343	78	147.29
11-20	$47,398	$4,400	$1,465,961	$1,517,759	105	134.73
21-31	$193,400	$97,334	$568,911	$859,645	88	130.95
Total August	$393,588	$111,734	$2,915,425	$3,420,747	271	137.66
September 1-10	$227,953	$39,571	$725,399	$992,923	110	139.72
11-20	$111,300	$35,100	$850,354	$996,754	82	139.78
21-30	$355,719	$570,130	$942,709	$1,868,558	[illegible]	[illegible]

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TABLE 15 (CONT.)

	Import Account	Export Promotion Account	External Account	Total Volume	Total Number Transactions	Average Exchange Rate
Total September (***)	$694,972	$644,801	$2,518,462	$3,858,235	294	138.98
October 1-10	$780,762	24862	871220	$1,676,843	100	139.70
11-20	$125,150	5500	1185337	$1,315,987	103	142.57
21-30	$73,769	165700	640701	$880,170	69	142.22
Total October (***)	$979,681	$196,062	$2,697,258	$3,873,001	272	141.46
November 1-10	$101,363	$77,410	$926,532	$1,105,305	93	139.53
11-20	$337,900	$68,089	$635,171	$1,041,160	79	139.58
21-30	$500,700	$39,280	$899,642	$1,439,622	93	140.83
Total November (***)	$939,963	$184,779	$2,461,345	$3,586,087	265	139.96
December 1-10	$315,882	$28,000	$1,198,403	$1,542,285	88	142.20
11-20	$371,000	$30,906	$821,000	$1,222,906	84	141.67
21-31	$402,723	$1,566,667	$752,679	$2,722,069	85	143.62
Total December (***)	$1,089,605	$1,625,573	$2,772,082	$5,487,260	257	142.48
January 1-10 1987	$194,780	$118,385	$654,454	$967,619	58	146.08
11-20	$349,020	$0	$739,663	$1,088,683	91	148.92
21-31	$780,112	$60,000	$735,788	$1,575,900	96	155.44
Total January (***)	$1,323,912	$178,385	$2,129,906	$3,632,203	245	149.36
February 1-10	$199,840	$20,600	$595,884	$816,324	65	153.82
11-20	$504,940	$345,273	$714,149	$1,564,362	85	147.84
21-31	$61,338	$0	$589,237	$650,575	56	150.95
Total February (***)	$766,118	$365,873	$1,899,270	$3,031,261	206	150.76
March 1-10	$178,490	$20,000	$948,953	$1,147,443	94	152.37
11-20	$840,600	$24,400	$965,501	$1,830,501	77	152.53
21-31	$387,400	$464,891	$1,396,195	$2,248,486	123	155.24
Total March (***)	$1,406,490	$509,291	$3,310,649	$5,226,430	294	153.48
April 1-10	$250,839	$18,300	$716,070	$985,209	94	155.77
11-20	$555,038	$216,674	$1,483,808	$2,255,520	125	156.93
21-30	$394,600	$7,750	$1,363,968	$1,766,318	116	159.88
Total April (***)	$1,200,477	$242,724	$3,563,847	$5,007,048	335	157.60

* The period from April 9-20, 1986, contains one $300,000 transaction at SoSh 100 = $1. This was included in the average. Without the transaction, the average rate would be SoSh 149.
** The second and third periods in July each contained one transaction of $200,000 from one Government Agency to another at a rate of SoSh 100 = $1. These are excluded from the account totals and the average rate.
*** For September and October, all transactions at exactly SoSh 100 = $1 have been deleted. In the past, such transactions involved sales from one Government Agency to another and the rate was not

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TABLE 15 (CONT.)

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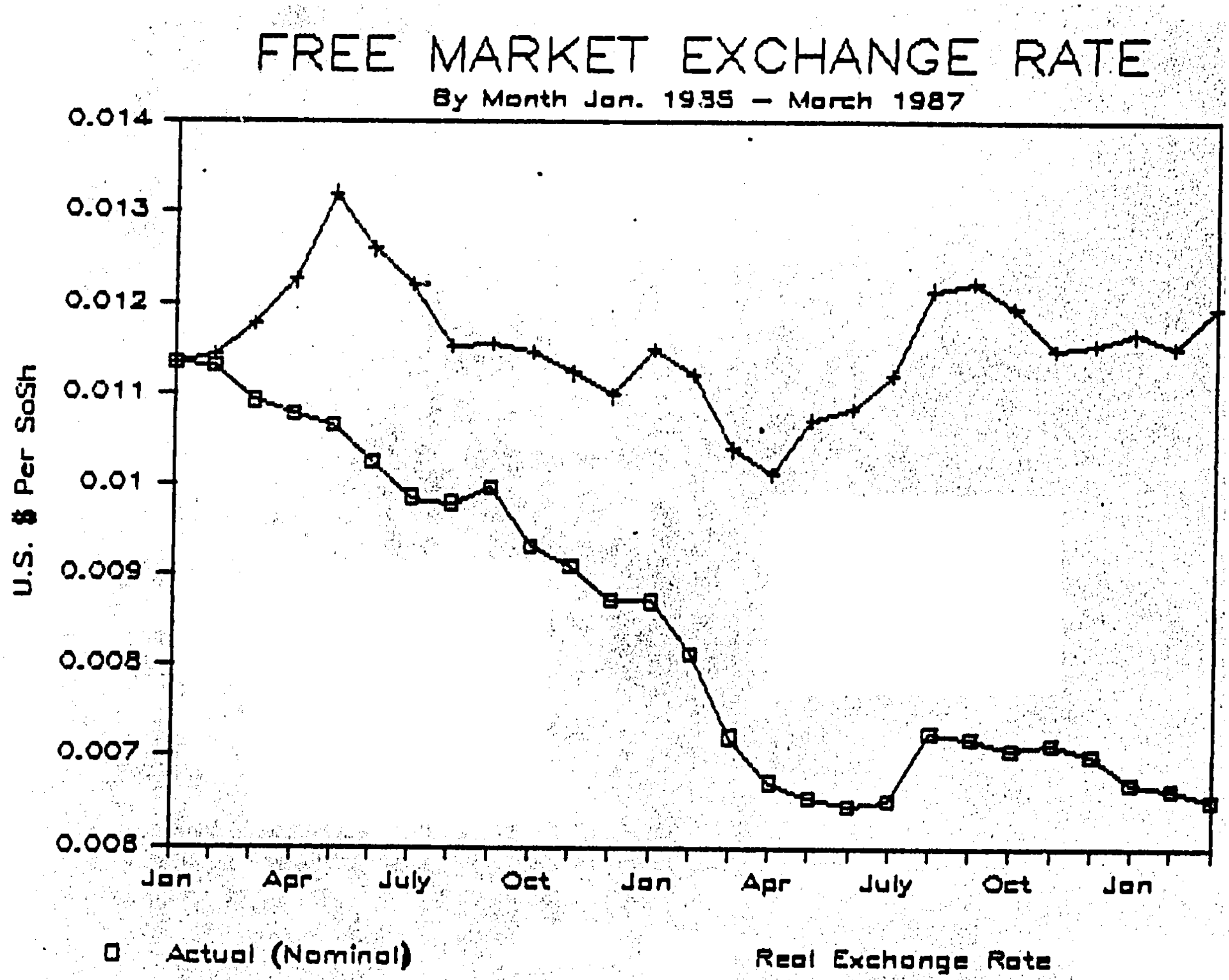
freely determined. Such transactions are no longer labeled as Government transactions, but we assume they are and have treated them accordingly. For November, 1986, through April, 1987, any transaction for a given day at 20 shillings or more below the average for that account have been eliminated and December, this resulted in removal of external account transactions at less than SoSh 120 = $1 and import a account transactions at less than SoSh 110 = $1. For February, one EPA transaction at SoSh 100 = $1 was elimin (one EPA transaction at 125, for a volume of only $18,600, and an External Account Transaction at SoSh 130, for a volume of $30,000, were included. They made little difference in the averages For March, there were two transactions at approximately 15 shillings below the average and they were included.

Source: Commercial and Savings Bank of Somalia

GRAPH 5



SOURCES: CENTRAL BANK OF SOMALIA AND COMMERCIAL AND SAVINGS BANK OF SOMALIA major trading partners, whereas in the first half of 1986, the increased price of imported goods may have fueled inflation. (This also, however, had the beneficial impact of discouraging importation.) The feeling among the donors, GSDR, and Somali public was that the free market was being influenced greatly by speculation. The first four months of 1987, the shilling has devalued 9.5%.

-5. Unification of Exchange Rates: In December, 1986, the GSDR was offered several options for a unified exchange regime. Two of them were an expanded auction mechanism for allocating most foreign exchange and determining the exchange rate for other transactions and a rate pegged to some group or "market basket" of currencies, with the rate adjusted periodically according to some formula, probably differing inflation between Somalia and the "market basket" group. The advantage of pegging an exchange rate to a group of currencies rather than to just one country's currency is the decreased vulnerability to changes in the value of the chosen country's currency vis-a-vis other major currencies. (E.g., when the value of the dollar was increasing vis-a-vis other major currencies a year ago, the shilling depreciated against the dollar, and would have done so even had inflation here been stable and other factors favorable.) Under a market-basket system, the shilling would have "floated" slightly each day versus the dollar and other currencies in the market basket, based on the daily changes between the dollar and the other currencies. This type of "float", however, would not make any adjustments for changes in the value of the Somali Shilling versus the other currencies. Some other system would need to adjust for relative inflation between Somalia and its trading partners, and even these adjustments would not account for other factors affecting the true value of the Somali currency as affected by such factors as decreased exports or confidence in the future. The GSDR chose to use an auction mechanism. Given the only viable options, we concur in the option chosen for unification.

E. REFORMS

The GSDR's structural adjustment program was initiated in response to serious economic and financial problems which were seriously exacerbated by the Ogaden conflict. The program, which got started in earnest in 1981, included a major policy shift toward market liberalization and adoption of a stabilization program. The structural adjustment program, which received considerable support from the IMF under three successive Standby arrangements, was designed to stimulate domestic production, reduce inflation, and attain a sustainable external position over the medium term.

The GSDR introduced a number of reforms in the 1981, 1982, and the first part of 1983. In addition to devaluating the Somali Shilling, the Government also closed three parastatals, liberalized private sector imports, increased interest rates, stopped automatically hiring all high school graduates, opened education and health services to the private sector, and instituted a number of important agricultural policy reforms. In addition to abandoning the policy of hiring all secondary school leavers, Somalia began briefly a campaign of encouraging and finding private sector employment for civil servants willing to leave Government employ. It is one of the few countries to do so.

The initial response to these reforms was dramatic; producer prices for most agricultural products increased significantly. In 1981, most producer price increases were from 30% to 50%, with producer prices for corn and sorghum- major agricultural commodities in Somalia- increasing 50% between the end of 1980 and 1981. Banana prices went up 100%. In 1982, the parastatal National Banana Board was converted into a joint venture company owned 60% by an Italian multinational and 40% by the GSDR.

Liberalization of marketing was one of the most significant agricultural reforms. The Livestock Development Agency was abolished in April 1981, and livestock trade is now conducted primarily by the private sector. The GSDR discontinued the requirement that fishermen sell their catch directly to the parastatal SOMALFISH. Since 1981, the National Trading Agency (ENC) no longer exclusively distributes foodstuffs to the private sector. Importation and distribution of most agricultural inputs were opened to the private sector.

Despite these impressive gains, the GSDR momentum to institute reforms slowed in 1984 in the face of social and political contraints. More expansionary fiscal policies combined with a drought and the Saudi ban on Somali livestock exports, resulted in deterioration of the economy and resurgence of inflation to almost 100% in 1984. Despite this, however, many reforms continued.

Liberalization of grain marketing through the Agricultural Development Corporation (ADC) and the Ente Nationale Commercio (ENC) proceeded over a period of years, with the major thrust coming between 1983 and 1985. ADC

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is responsible for procurement of domestic grains and distribution of imported corn. ENC has responsibility for distribution of imported rice, wheat, and wheat flour. It also has major responsibility over distribution of such commodities as cooking oil and sugar and the pasta factory. (ADC is under control of the Ministry of Agriculture, while ENC and the pasta factory are under the Ministry of Commerce.)

ADC's monopsony buying power began in 1971, and farmers were allowed to retain only 100 kg of grain per person for domestic consumption. The remainder was sold to ADC at fixed, official prices. The GSDR began relaxing restrictions in 1979, and by 1983, farmers were required to sell only 10% of their output to ADC. The amount was reduced to 5% in 1984 and abolished in 1985. During the transition period, some uncertainty remained concerning the role of ADC and the right/ability of private wholesalers to enter the market. Between 1983 and 1985, the results were dramatic. According to World Bank figures, corn production increased from 235,000 tons in 1983 to over 380,000 in 1985. Although the increase resulted partly from excellent weather, adequate incentives from liberalized pricing also played a major role.

Backed by a new IMF Standby, the GSDR moved in 1985 to restore public confidence in the movement toward a free market economy. The rate of inflation was reduced to 35%. Since 1985, additional reforms were undertaken to promote free enterprise. In 1985, most remaining price controls were de facto eliminated. The official exchange rate was devalued,and a free foreign exchange market was opened, allowing the market to allocate foreign exchange. Virtually all import and export controls were de facto eliminated. A Chamber of Commerce was established. While there are still price controls on petroleum products, diesel and gasoline prices are now at import parity levels. Private banking laws were drafted, but not enacted. In 1986, the GSDR allowed some veterinary drugs to be imported by the private sector. Tax administration was reformed, and tax receipts increased significantly, though the budget continues to be a problem, and tax avoidance is increasing.

While the record of reforms undertaken by the GSDR is impressive, additional reforms are still required to alleviate current economic and financial problems and to move toward a better economic future.

F. CONCLUSION

Somalia is one of the more extreme examples of a developing country, starting with a low per capita income, very limited resources, a largely unskilled labor force, and a rapidly growing population. Under- and unemployment are high and will become increasingly more of a problem in the future, as population pressure increases on the fixed land base. Insufficient health facilities and services (part of the low real income) and an inadequate education system result in large part from insufficient

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fiscal revenues to finance more rapid improvements. Rapid population growth, by increasing the need for such services, makes it even more difficult to achieve improvement.

Strong investment incentives are needed to encourage investment in more productive agricultural activities and in non-agricultural activities that will generate productive jobs and income at a much higher rate than at present. Government revenue collections must be increased (both by increasing the productive tax base of the country and by improving tax administration itself) and unproductive expenditures must be curtailed t permit more resources to be invested in priority economic and social services and infrastructure, without generating large fiscal deficits an the consequently high rates of domestic inflation that discourage long-run productive investment.

Productive investment and the effective utilization of current productiv capacity are both seriously inhibited by the current, severe scarcity of foreign exchange for imported inputs and consumer incentive goods. Somalia's inability to service its huge foreign debt overhang, while at the same time providing even the minimum amount of foreign exchange needed by the private sector is also a severe constraint. New investmen must therefore be directed toward those activities that can do relativel more to conserve and earn foreign exchange, as well as to better utilize domestic resources and provide employment. The adoption and maintenance of a realistic foreign exchange rate is one of the most important among the investment incentives that would contribute toward achieving these ends. Other reforms will be necessary, however, as the present system rewards trading at the expense of medium to long-term investment or employment generating industry.

By discouraging production for export and for efficient import substitution, and by encouraging consumer imports over domestic production, the overvalued exchange rate of recent years has contributed strongly to the problem.

This ESF Program is designed to encourage and support the Government in its current efforts to improve and sustain a foreign exchange auction system as a workable, politically acceptable method of establishing and maintaining a market-determined rate of exchange for the Somali shilling. This is a matter of high economic priority with potentially large benefits to the economy. The use of market forces to determine the most appropriate exchange rate each month is especially important during a period of high domestic inflation, since administratively-determined rates are politically difficult to change sufficiently fast even to maintain purchasing power parity, let alone to adjust for changing market conditions and underlying shifts in supply and demand.

IV. ROLE OF OTHER DONORS

A. World Bank

The World Bank is providing balance of payments assistance through the Agricultural Inputs Program (AIP) II. The Program provides for approximately $70 million over a one and a half to two year period. The first tranche of $35 million provided approximately $25 million in cash to the private sector through the donor auctions. Most of the remainder will provide petroleum. The World Bank began auctioning funds September 1. (USAID began contributing FY86 ESF funds to the auction beginning with the Feb. 3 auction.) The second tranche is being negotiated and an additional $25 million, plus additional funds channeled through the World Bank by the Japanese, are expected to help fund the new auction system when it is established. Other countries, Great Britain and Japan, are contributing balance of payments assistance to the auction through the World Bank. The first tranche of AIP II should be disbursed by June or July.

B. Italy

The regular Italian aid program has provided approximately $5 million to the donor cash auction under the 1986 program. The money can only be used to finance letters of credit for Italian goods. No distinction has been made, however, regarding the source of funds when auctions are conducted. To ensure that no more funding is budgeted from Italy than will actually be forthcoming, Italy is providing about $400 thousand per auction, which is a smaller percentage of total purchases from Italy from earlier auctions. The remainder of the Italian CIP- approximately $6 million- is going to the public sector. The disposition of 1987 funding still needs to be determined.

C. FRG

The Federal Republic of Germany has a regular CIP, providing DM10 million over a two year period. Half of the funds will go to the public sector and the remainder to the private sector. FRG does not intend to support an auction system.

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D. IMF

The IMF will be taking the lead on the new, unified auction structure, working with the GSDR to finalize auction procedures. An auction mechanism was one of the two major unification procedures presented to the GSDR. The IMF has supported the donor-auction concept since it was first proposed by USAID in the spring of 1986. They provided an IMF expert in early June, 1986, to make suggestions on the auction structure. Eventually, the IMF and World Bank jointly established auction procedures for the donor auctions. For the donor auctions, the IMF and World Bank jointly determined the amount of funding provided per auction.

V. PROPOSED PROGRAM

A. Problem Being Addressed--Reform Being Supported

The program purpose is to support Somalia's structural adjustment program for foreign exchange rate unification through an auction system. This should help the economy function more smoothly and lessen some of the balance-of-payments problems. Somalia suffers from a severe foreign exchange shortage. There is an anticipated trade deficit for 1987 of $311 million. The country entered 1987 with arrears on debt of $157 million by latest estimates. Somalia has reached concurrence with the IMF on a new Agreement, and recently obtained bridge financing needed to pay arrears to the IMF. The program will go the the IMF board in June. A Paris Club rescheduling session in the next few months is scheduled for mid-June. Nevertheless, rescheduled debt payments could be over 50% of exports for 1987, making debt a continuing problem in meeting foreign exchange needs.

Assuming that the balance of payments problems and foreign exchange shortage can be alleviated in one or two years is unrealistic. The problems will continue for at least a decade, and to have an impact, we should be prepared to support and encourage policy reforms which promote productive activity and avoid waste. We also need to provide the immediate balance of payments assistance necessary to sustain the economy in the short run.

The opening of the free market has been a major step toward creating a sound economic climate. Prior to the free market, the GSDR determined what would be imported and by whom. We are pleased by the move away from the "planned" economy toward a market mechanism for allocating goods. In general, this system is far superior to any system leaving decisions to individuals or groups. With the opening of the free market, the GSDR has de facto abolished virtually all import restrictions. This movement toward free trade is strengthening the economy.

Without a market-determined exchange rate giving the appropriate pricing signals for international transactions, domestic pricing and production reforms cannot succeed. Since the beginning of discussions on unification, we have known that neither the GSDR nor the IMF was likely to ask for or accept a unified system which floated freely. Sentiment against such a system increased in the first four months of 1986 when the free market rate devalued 23% and in late August, 1986, when the shilling appreciated 27% from the June high due to anticipation of extremely large donor cash auctions. (The appreciation of the shilling occurred at the peak export period.)

Through FY86 ESF conditionality and policy dialogue, we have been pressing for a unified system which is as market-determined as possible. An auction mechanism will become the mechanism for determining the exchange rate following unification. We can help ensure the success of that reform program by providing a steady flow of funds into the auction and augmenting the total volume of foreign exchange available for auction.

B. <u>Proposed FY87 ESF Program</u>

-- 1. <u>Background</u>

A new IMF Agreement will result in unification of the free market and the official rate, through an auction mechanism. USAID proposes to utilize between three and five million dollars for public sector priority needs, probably debt payment. The remainder of the $15 million ESF Program will to to the expanded cash auction. We view this as crucial in our ongoing efforts to maintain an exchange rate that is market-determined or as close to market-determined as possible. The exact mechanisms for auctioning have not yet been determined, though most guidelines have been set and are described below.

Exact regulations will not be known until auctions are ready to begin. The regulations may, in fact, depend partially on the timing of initial auctions and whether there is a lag between donor auctions and the new system. There will again be the need to match regulations of different donors providing funds to the program. For this reason, we are encouraging the GSDR and IMF to consult with us when determining auction regulations to be sure the guidelines meet our new regulations. Funds going to the auction will come from export proceeds, which will all be surrendered to the Central Bank at the previous auction rate, with a portion going to the auction, and donor funding. USAID funds would become part of the total volume of auction funds. The World Bank will make the second tranche of auction funding available in June or July. The GSDR and IMF have not yet determined whether funds from private companies and individuals will go to the auction, as occasionally occured until the May 17 auction or will be sold directly to the banking system at the auction rate, as occurred beginning with the mid-May auction. We believe the determination should depend on the need for auction funds

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versus the supply from other sources and that private sector funding should not augment auction funds above the agreed-upon level. This view was part of the rationale behind the procedural change May 17.

-- 2. <u>Proposed Auction System and USAID Role</u>:

The GSDR and IMF are finalizing auction procedures for an expanded version of the donor cash auction. This will fund imports under procedures extremely similar to the present donor auction. The major difference will be the cessation of new import and export promotion accounts for funding imports. All export proceeds will be surrendered to the Central Bank at the auction rate and a portion, jointly determined by the Fund and GSDR, will go for auctions. These export receipts will, and must, be supplemented by donor funding if there is to be sufficient auction foreign exchange to meet IMF targets regarding private sector importation. Services will not be funded through this auction, but through another mechanism, under present plans involving an auction of funds originating outside the country, e.g., remittances. The GSDR may possibly allow importers to bid in either auction.

Procedures for financing imports are thus fairly well established but will not be completely known until auctions start, and there will undoubtedly need to be some modified as the process proceeds. Under the donor auction system, we placed funds into the auction under regulations recently established between the World Bank and AID (see Annex A). The GSDR and World Bank intend to continue allowing imports only from the present list of eligible countries.

The IMF and GSDR had intended to unify exchange rates and begin the expanded auction system with the May 16 auction. USAID funds have been exhausted, however, and all that remained were Italian funds and the portion of World Bank funds not claimed during earlier auctions. These allowed an auction the first half of June, but were not be sufficient to permit unification at the auction volume desired by the GSDR, World Bank, and IMF and to permit closing of the free market. Now that the second tranche of World Bank funding appears close to availability for auction, unification and the expanded auction may begin soon.

Under existing World Bank regulations for donor auctions, funding goes directly into a commercial bank for direct payment to suppliers. The GSDR is planning a system similar to the present one in this regard. The GSDR plans, however, to prohibit opening of new import or export promotion accounts in the free market. Therefore, funds in existing "import accounts" may only be used for importation by the owner; they may not be resold. Not only does this mean that import account and EPA foreign exchange may not be used for speculation, it restricts the ability of the importers' flexibility in changing decisions. In this regard, we would prefer the free market system, whereby auction funds go directly into import accounts for use under the present regulations but do not have sufficiently strong feelings to press on this issue.

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We do not believe the auction should restrict items which may otherwise be imported with free-market foreign exchange. This includes food, with the possible exception of sugar if the GSDR can prove that domestic sugar production is sufficient, and it probably cannot. If the auction price is close to a market price, this alone will protect viable domestic agriculture and other industry. (The World Bank basically holds a similar view.) When necessary for temporary purposes, tariffs can be used to protect infant industries or those of critical national importance. These, however, should be used with extreme care as they usually result in protecting industries which will never be viable or in providing incentives for industries to remain non-competitive.

The Minister of Agriculture contention that the food imported through donor auctions has hurt farmers is not borne out by a recent World Bank study, now in final preparation. If anything, it is the existence of subsidized donor food, and the timing of any donor food, which is the determining factor. Food imported and sold at market prices has not been a problem for agriculture. Food sold at subsidized prices has. The only exception is possible the infant rice industry, which may never be competitive. The donor auctions initially provided highly subsidized foreign exchange, much of which was used to import food items. This is no longer the case as the auction rate is near a market-determined one. (Since February, the auction rate has been between 83 and 90 percent of the free market rate for import accounts.)

Regarding use of different regulations for USAID funds in general, we feel the same or similar auction rules must apply for all funds since some auctions will have more funding from one source than will another. Varying regulations according to source of funding would result in different auctions having different regulations, something to be avoided at all costs. For instance, if the World Bank reaches agreement with the GSDR on a unified system and regulations for new auctions, the free market could be closed and auctions could be introduced in June. The signing of our Grant Agreement and meeting of Conditions Precedent might not take place until a couple of months later, in the middle of the export season. We would prefer to have as much as possible of auction funds met through export proceeds during that season to avoid their being spent for other uses. Even if the export proceeds go into an escrow account, their existence for long periods could create political pressures. Thus, we may be funding up to half of each auction for a given time.

Prohibiting importation with USAID funds of food or other specific commodities now allowed by the GSDR could greatly affect bidding actions. We are somewhat concerned over the large percentage of auctions presently going for food--over 50%, but the type of food varies over time. In addition, we do not want to discourage private sector decision making.

Regarding eligible countries for use of A.I.D. funds, the original donor auctions limited the list of suppliers to "World Bank eligible" countries. This essentially included all countries with which Somalis had business dealings. We would restrict use of A.I.D. funds to opening of letters of credit from code 935 countries. Since virtually all letters of credit opened under the original auction came from these countries, such a regulation would have little affect on administrative responsibilities or on auction purchases and bidding decisions. As long as USAID was not the sole funder of any auction and Somali import practices did not change significantly, there would not be an impact on auction decisions.

If USAID funds are tied to U.S. procurement regulations, however, we are virtually certain that the vast majority of our funds would go unclaimed. The Italians were able to tie their funds to Italian procurement only because of the very small percentage contributed to each auction in relation to goods bought from Italy and a World Bank guarantee to "subsidize" any shortfall. To avoid subsidizing the Italian contribution, the World Bank purposefully set the Italian contribution below the lowest percentage of goods purchased from Italy.

USAID funds tied to U.S. procurement regulations will undoubtedly result in the same system as occurred with the U.S. CIP in FY85. Our funds were sold at SoSh 85, while the free market was SoSh 114, and the private sector still preferred the free market. The private sector continued to prefer the free market when the rate rose to SoSh 130. (We do not know what the reaction would have been when the free market rate rose to SoSh 150 since we were already re-programming our funds for public sector petroleum.)

More importantly, we are placing the majority of our ESF funds into an auction system to support an innovative reform measure. The GSDR chose to use a market-determined mechanism when selecting a method for unifying the free market and the official rate. This decision was made largely because of USAID conditionality and policy dialogue aimed at stressing the benefits of a realistic exchange rate and of allowing market forces to determine pricing and production decisions for the economy. Eliminating food and/or restricting USAID funds to U.S. procurement regulations goes against all the reforms we have been trying to institute.

We believe the high auction rate since mid-April, and especially the devaluation of the free market since mid-January, has been due in large measure to uncertainty over the future of auctions and the free market. Nevertheless, the auction rate is now up to 90% of the free market rate despite greater restrictions on auction foreign exchange, indicating market mechanisms are working with the auctions. For most auctions, bids tend to cluster around the lowest successful bid. This appears to be a result of similar views regarding the "accurate" rate rather than collusion. The majority of bidders request less than half the maximum volume allowed, which is $200,000. Indeed, for most auctions, the majority request about one fourth or less than the maximum, making it more likely that these bidders intend to use the funds themselves and are not acting as agents for one or two large traders.

-- 3. Impact of Donor Auctions and the Free Market on the Mix of Imports:

Both the auction and the free market in general favor importation of tradable goods rather than commodities for medium to long term investment. This is to be expected given the quick, and relatively large profit from trading. In addition, there is sufficient uncertainty to make people avoid expanding or even maintaining capital equipment. The latter, indeed, can probably best be accomplished through a project approach.

The February, 1987, World Bank Report estimates free market imports for 1985 (the first year of the free market) at $42.9 million. Forty percent of this total went for food, beverages, and tobacco. Construction materials accounted for 33 percent, but we do not have a breakdown on the type of construction. Twelve percent went for transport equipment, primarily passenger cars. Only 17 percent went for industrial inputs (raw materials, machinery, and spare parts). Since these are private sector imports, petroleum, which was approximately 35% of total imports for 1985, are not included. Ostensibly, and implied in the World Bank report, industrial enterprises preferred waiting for cheaper CIP funds. In 1985, however, CIPs required a shilling deposit equal to the Commercial Bank rate of almost SoSh 80 = $1 for buying dollars in January, 1985, rising to SoSh 85 = $1 for the remainder of the year by June. The free market emerged at a rate of SoSh 88 = $1 in January, was over SoSh 100 by summer and SoSh 114 by December, 1985. With the differential between approximately SoSh 85 for CIP financing and SoSh 114 for the free market, both the USAID CIP and the World Bank CIP had difficulties finding legitimate buyers. The problem persisted until February, when the free market rate was SoSh 123 and USAID decide to re-program the remainder of the private sector FY85 funds for the public sector. Some countries have fewer regulations and a shorter transport distance. Nevertheless, the industrial sector seems to need a large differential to make a CIP attractive now that there is the free market, and since Sept. 1986, an auction.

This does not mean we are not concerned with the lack of investment goods being imported through the free market or auction. For developmental purposes, we would like to see more true investment. Nevertheless, although we believe our CIP was fairly successful in helping develop the private sector and did encourage productive enterprise, most donor CIP funds do not appear to go for true investment goods or for employment generating industries. Business prefers to utilize existing capacity, even letting existing machinery deteriorate, rather than buy medium- to long-term investment goods. Businessmen prefer to purchase raw materials and other inputs for production. There may be more of this type of purchase under a CIP or AIP than a free market or auction, but with a

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free market, such purchases are only made with highly subsidized foreign exchange. Given the Somalis' historical background as traders and uncertainty over the future, the best mechanism for encouraging purchases for medium-term investment or for employment generating industries seems to be through projects aimed at this area.

-- 4. Proposed Public Sector Grant:

USAID proposes to give five million dollars as cash to the public sector. Acceptable uses would be payment of debt, either to multilaterals or to U.S. commercial banks for repayment of loans made to discharge debt to multilateral institutions, purchase of petroleum, or payment for Somali embassies abroad. In all of these areas, the GSDR has a need for foreign exchange which cannot presently be met because of the present lack of export proceeds.

Petroleum is needed at regular intervals throughout the year. In recent months, there have been severe shortages and long lines. The estimated need for foreign exchange for petroleum for 1987 is $50 million, with only $20 million pledged for petroleum by donors at the Consultative Group meeting. The debt owed to multilateral institutions far exceeds the resources at A.I.D.'s disposal. According to information provided by the World Bank at the Consultative Group meeting in April, 1987, the debt service obligations owed to multilaterals in 1987 are $85 million. Arrears to these institutions at the end of 1986 were $29 million.

There is no way the ESF program can make a sizable contribution toward these debts. In addition, we believe the GSDR must begin developing a long term mechanism for meeting these debts and payments to embassies. The eventual solution to a large portion of the funding problem for petroleum is privatization of the industry, but this will not occur immediately. In the meantime, the GSDR will have difficulty meeting its obligations, but the Government will have some sources of cash which can be used for debt repayment, petroleum purchases, and payment of embassy expenses when the export season begins in a couple of months. It may prove impossible to pay all debts and/or meet its other obligations, but the major issue concerning the GSDR's ability to meet immediate payments is one of timing.

The GSDR will provide up to 50% of export proceeds to the unified auction system. The exact percentage will be determined after deciding the amount of donor funding available for the auctions and the total amount of funding the GSDR and IMF consider necessary for the auction. This latter sum will be based on the IMF targets and a consideration of relative priorities among various needs for foreign exchange. A well run auction and maintenance of a realistic exchange rate are high priority. Consequently, any funds which A.I.D. places into the auction will release a corresponding level of export proceeds from the auction, to other uses such as debt repayment, petroleum purchases, or payment of embassy expenses. This will not happen until the export season begins, however. At present, the GSDR does not have sufficient export proceeds. There are several critical payments which need or needed to be made. Some required obtainment of bridge financing. One such loan is a recent loan for repayment of arrears to the IMF, necessary to bring the IMF Agreement before the IMF board for approval. The GSDR did not have sufficient funding to pay the approximate $29 million to the IMF. The Italian Government gave $7 million. The GSDR received a bridge loan of $22 million for the remainder. Prompt repayment of this loan is needed to avoid costly interest charges which the GSDR cannot afford. This is just one example of current or recent expenses which must be paid or needed repayment before the export season.

We consider payment of debt, purchases of petroleum, or payment of expenses of embassies abroad to be the acceptable and priority uses for the ESF cash payment. Deposits for the first tranche of funds will be made at the highest legal exchange rate at the time of deposit. At present, this is the rate of the import auction. Should an auction for service payments be established and the rate for this auction exceed that of the import auction, the applicable rate will be the rate of the most recent service auction.

-- 5. <u>Maintenance of Separate Accounts</u>:

For the FY86 ESF Program, USAID funds for the public sector were placed in a commercial bank account designated by the GSDR. Funds for the auction were placed in an auction account in a U.S. commercial bank. There was a similar account for auction funds provided by the World Bank. According to regulations applying to FY86 funds, USAID and World Bank funds were commingled into a concentration account at the discretion of the commercial bank, which placed funds into the concentration account as letters of credit were verified.

For the FY87 Program, the public sector funds will again be placed in a commercial bank account designated by the GSDR, for use for any of the above designated purposes. For the auction, USAID funds will go directly to the commercial bank account designated for the auction. The account will be similar to the USAID/Government of Somalia account which already exists and which may only be used for funding auctions. Funds in this account will not be commingled, however, with auction funds of the World Bank, any other donor, or the GSDR. Any interest accruing to the account will remain in the account to be used solely for verifying letters of credit under the auction.

The correspondent bank will ensure that funds in the USAID/GSDR auction account go only for verifying letters of credit from Code 935 countries and that any interest accruing to the account will also be used only for that purpose. Periodic bank statements will be provided by the correspondent bank showing deposit of A.I.D. funds, the amount of interest accruing, and withdrawals from the account. A list of letters of credit verified from the account will also be provided and will indicate the source and origin of each letter of credit as well as the commodity purchased.

With regard to local currency, a separate account will be established for the initial deposit of local currency generated from the various facets of the FY87 Cash Sales Program. The GSDR will provide USAID with bank statements verifying the deposits. Any withdrawals, either for direct use (such as general budget support) or into the Domestic Development Department of the Ministry of Finance, will require USAID concurrence. Any FY87 ESF funds going into the DDD will also be placed into a separate account to allow tracking of funds, based on the different regulations regarding valid local currency expenditures for different programs for different years. Ten percent of the local currency generations will be used to fund the USAID program in Somalia. The remainder will be used according to Mission priorities. For FY86, approximately 25% of the local currency was used by the GSDR to purchase foreign exchange for debt repayment. Most of the remainder went to support development projects. We anticipate a similar type of distribution for the FY87 program.

The exchange rate for the auction portion of the program will be the applicable auction rate. For the public sector portion of the program, the rate will be the highest legal exchange rate at the time of deposit.

C. Potential Problems to Overcome in Auctions:

Under a unified exchange system with the rate set through an auction mechanism, both the system and our ESF program would be similar to the one implemented by USAID/Zambia prior to suspension of auctions. There are some major differences between Zambia and Somalia which would affect auction success. In some respects, establishment of a general auction system would be easier here because of the existence of donor auctions for cash for financing imports. A modified version of an auction is already in place. The Government is familiar with the system, and the procedures for taking bids and deposits and for collecting the remaining local currency are working extremely smoothly. The public is familiar with auctions and now has confidence in the integrity of the system. We anticipate less difficulty in modifying the auctions than in starting from scratch. The public will, however, have to adjust to a system of one exchange rate and an auction mechanism as the only method of determining the exchange rate.

The major problem areas relate to the timing and volume of funds. With respect to timing, export receipts in Somalia are concentrated almost solely in a one to two month period, during the Pilgrimage season. When these receipts enter the free market at one time, there is little impact on the exchange rate. It drops slightly, but not by much. Apparently, the public is used to the seasonality and adjusts accordingly. The Somalis have had decades of experience buying foreign exchange on the black market in Jidda and are aware of the seasonal variations. In addition, with the free market, someone buying foreign exchange from an exporter during the peak season can hold the funds in his/her account and re-sell it later. From what we have seen of donor auctions to date, the auctions are slightly more sensitive to changes in supply, though not to the extent we would have expected. More importantly, if export proceeds are placed in the auction when they are received by the Government, there will be periods when virtually the only foreign exchange available for auction comes from the donors. If the GSDR and IMF concur on an auction mechanism, this is one of the features that will need to be discussed. The decision reached will affect timing of donor inputs.

Regarding volume auctioned, we anticipate that the GSDR will have the same tendency as the Zambian Government to place large amounts of foreign exchange into auctions in an attempt to reduce the exchange rate. The GSDR reacts adversely whenever the shilling devalues. The Government is not convinced of the beneficial impact on exports or of the importance of the exchange rate in controlling importation. In each of the sixth and seventh auctions, the Central Bank added $400 thousand to the $1.9 million of IDA funding to keep the volume auctioned at the $2.3 million level that had prevailed for the first five auctions. This represented foreign exchange the Government desparately needed to pay critical debts. Fortunately, the Somali Government itself realized it had greater needs for the foreign exchange and let the volume auctioned fall to $1.9 million.

For the February 3 (tenth) auction, the Minister of Finance raised the level to $2.9 million. Unfortunately, he had been given the impression by World Bank officials in Washington that the $2.9 million level was acceptable, and he announced the auction immediately after his return to Somalia. With Washington officials having indicated that $2.9 million was acceptable and with that level already publicized, World Bank and USAID officials in Mogadishu had difficulty convincing the Minister that he was incorrect. He has since agreed to abide by World Bank and IMF guidelines and has done so.

We anticipate that there will always be a desire on the part of the GSDR to increase the volume of funding for any and all auctions. At present, officials would like donors to provide as much foreign exchange as is requested. From past experience, we know it is possible that the Government will add funds to any given auction unless procedures make such actions absolutely impossible. If past experience is a guide, however, these actions will be isolated. We do not anticipate any more desire to increase the volume of funding in a comprehensive auction than in the present auction since the GSDR hoped to use the present auction rate for setting a unified rate and wanted it as low as possible. The Grant Agreement would provide for suspension of U.S. contributions to the auction if the GSDR exceeds IMF approved limits. USAID funds would be placed in the auctions again only when the GSDR returned to the approved level.

Allocating small amounts of foreign exchange outside the auction system, e.g., through the banking system, may present some difficulties. Zambia has a private banking system, which bid for foreign exchange at auctions, for distribution to the public between auctions. Somalia has no private banks. The only commercial bank in Somalia is Government owned and run by the Ministry of Finance. Consequently, there is more chance that foreign exchange allocated through the Commercial Bank in the interim between auctions would be allocated on a political basis. This increases the need to monitor activities of the bank and to press hard for private banking.

VI. Administrative Procedures

A. Responsibilities of USAID:

With few exceptions, responsibilities of the Mission in implementing the program once enacted will be minimal. Although it will be necessary to monitor and evaluate auctions, and this can be a time consuming process, such activity will be necessary whether USAID participates in auctions or not. Regular monitoring and evaluation of anything affecting the balance of payments system and foreign exchange regime are necessary under any circumstances. Responsibilities created because of USAID participation in an auction entail (a) monthly or twice-monthly cables to Washington requesting release of funds into the auction account; (b) receipt and verification of records giving the total amount of funds auctioned and the amount coming from USAID; and (c) verification of deposit of the correct amount of local currency. Ten percent of the local currency will be used by USAID for operating expenses. The remainder will be jointly programmed by USAID and the GSDR for critical development priorities. Monitoring the use of local currency for development projects will follow present procedures in the DDD unit, whereby local currency is jointly programmed by USAID and the GSDR. Monitoring of local currency used for such activities as debt repayment and budget support will follow procedures presently being modified in the Mission.

B. Responsibilities of the GSDR:

The Central Bank is responsible for conducting the current auctions. It is the most likely agency for conducting a more comprehensive auction, too. At present, auctions are managed and administered by a committee composed of the Minister of Finance, the Minister of Commerce, the

Governor of the Central Bank, the President of the Somali Development Bank, and the President of the Commercial and Savings Bank. We would expect the composition of the committee to remain the same with the possible exception of the addition of the IMF resident representative as an official committee member. The Central Bank is and will continue to be responsible for ensuring the integrity of bids from the time received until bids are opened. Given the method used for providing the 50% shilling deposit when submitting bids, the return of deposits to unsuccessful bidders is almost automatic and accomplished within one day of each auction. We anticipate that this procedure will continue. The Central Bank will collect the remaining deposit from successful bidders. It will also provide USAID with information about the total dollar amount auctioned, the percentage coming from USAID, the final auction rate, and the bank statement ensuring the proper amount of local currency has been deposited in the GSDR-USAID auction account. Ten percent of these funds will be used by USAID for operating expenses. The remainder will be jointly programmed by USAID and the GSDR.

C. Disbursement Schedule:

-- 1. Pipeline for FY86 ESF: Out of FY86 ESF funds, the $10 million for the public sector was disbursed in October, 1986. The Grant Agreement provided for a six month period for establishing auction procedures acceptable to A.I.D. If an acceptable auction procedure could not be established in that time period, the remaining funds would go to the public sector as a cash grant. Acceptable auction procedures were negotiated the end of January, 1986, and the necessary documents verifying that all parties could and would follow those procedures were signed by mid-February. USAID has been funding a portion of all letters of credit confirmed by Citibank since deposit of A.I.D. funds February 19. Of the $11.011 million for auctions, the entire amount has been disbursed into the GSDR-USAID auction account. Of this, the entire amount will help fund letters of credit for auctions held through May 16.

-- 2. Disbursement Schedule for FY87 ESF: At present, auctions take place twice a month. If an auction mechanism becomes the mechanism for unifying exchange rates, we anticipate weekly or twice-monthly auctions. We plan to disburse funds into the auction account monthly, to retain some leverage over continuation of adequate procedures. We anticipate the full amount of ESF funds would be disbursed over a period of 12 months from the first auction under a unified system. To maintain maximum leverage, we intend for our funds to be disbursed over a period of nine months from the date we first participate in auctions.

D. Records and Auditing Rights:

USAID will retain the normal auditing rights for the foreign exchange and local currency accounts. The Grant Agreement or Project Implementation Letters will identify the necessary records which will need to be maintained and will specify the need to guarantee our access to them for at least a three year period.

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E. Resources for Program

-- 1. Foreign Exchange: This program proposes to grant the GSDR $15.5 million of foreign exchange which will be auctioned through the existing auction system if it remains or through a broader auction system if one is introduced. While this amount of funding is not sufficient to resolve Somalia's balance of payments difficulties, it is sufficient to ensure a viable auction mechanism. At present, auctions are held twice a month. Under an expanded auction system, auctions would most likely be held weekly or twice a month. In either case, we anticipate providing approximately $1.3 million per month. We expect the IMF to establish a level of disbursement for auctions. In order to provide a relatively stable supply of foreign exchange to the private sector throughout the year, the final disbursement schedule for USAID funds will depend on the timing and availability of other donor and GSDR resources for the auction.

-- 2. Local Currency: This program will generate a significant amount of local currency. Under the present auction system, bidders deposit the local currency equivalent of half their total bid prior to the auction date. For successful bidders, the remainder of the shillings must be paid within three business days of the auction. By the third day, the local currency equivalent of the USAID contribution to the auction is placed in a special account at the Central Bank for ESF shilling generations. Since the exchange rate varies from auction to auction and can be expected to continue doing so, the exact amount of local currency generations cannot be predicted. Based on present auction rates and the assumption that the rate will remain stable or increase, we project from SoSh 1.8 to SoSh 2.3 billion from the program. A description and illustrative list of local currency programming is attached in Annex E.

VII. U.S. SPECIAL INTERESTS

Somalia's strategic location in the Horn of Africa along the vital shipping route between the Persian Gulf and Europe makes it a particularly important country to the United States. It is important that Somalia continue its movement toward a closer relationship with the West under its current government as well as under possible future governments. Also important is Somalia's role in rapprochement with Ethiopia and maintenance of peace in the Horn. Very important aspects of the relationship between our two governments are a joint defense agreement, the GSDR's provision of military access rights to the USG under a 1980 Agreement, and the USG's military and economic assistance to Somalia. Military assistance focuses on providing the GSDR with the training, leadership capability, and materiel needed to defend itself against outside aggression. Economic assistance focuses on short-term economic stabilization, building a base for long term development, as well as current humanitarian considerations such as the care and feeding of a large number of refugees.

VIII. CONDITIONALITY

A. Conditions Precedent

Prior to the first disbursement of funds under this program for a foreign exchange auction, or to the issuance of any documentation pursuant to which such disbursement may occur, except as A.I.D. may otherwise agree in writing:

(1) The Grantee shall provide to A.I.D. written evidence, in form and substance acceptable to A.I.D., that it has established a foreign exchange auction which operates in a free market manner acceptable to A.I.D.; and

(2) The Grantee shall provide to A.I.D. written evidence, in form and substance acceptable to A.I.D., that it has collaborated with the IMF to determine the amount of funding needed for the auction system for at least a year and to establish a mechanism for ensuring a steady flow of foreign exchange into each auction. Any variation in the supply of funds to the auction will require the concurrence of the IMF and will need to be justified on the grounds of seasonal fluctuation in demand for foreign exchange. In the event of any deviation from this formula for determining the timing and level of funds auctioned, A.I.D. disbursements to the auction will cease until either the Grantee returns to the original schedule or until A.I.D. receives and concurs in writing to any change in schedule.

There are no conditions precedent to disbursement of funds for the public sector.

B. Covenants:

The Grantee shall covenant, except as A.I.D. may otherwise agree in writing, that:

(1) It will maintain a foreign exchange auction system acceptable to A.I.D. through the terminal date for disbursement of funds under this program; and

(2) It will collaborate with A.I.D. on policy dialogue and studies over the life of the program geared towards establishment of a three-to-five year policy reform agenda focused on civil service/tax reform/public expenditure budget rationalization and related sectoral reform.

ANNEX A

Existing

Procedures For Auction Of Dollars By The Central Bank Of Somalia

The Central Bank of Somalia will conduct a series of foreign exchange auctions until further notice. The auctions will be conducted on a free and competitive basis and will take place approximately twice monthly.

1. The foreign exchange to be sold to successful bidders shall be used to finance imports of a broad range of goods. A list of goods not eligible to be financed through the auction - the "negative" list - is annexed. Imports of any commodity not shown on the negative list are eligible to be financed through the auction. The imports will be effected through established procedures and be subject to Somali law.

2. The dates of auctions will be confirmed and the amount of foreign exchange to be auctioned will be announced and widely publicized at least three business days prior to the auction day.

3. Any individual, private enterprise or public enterprise (except the National Petroleum Agency and the banks) can participate in the auctions, and are invited to submit bids to the Central Bank of Somalia. Each bidder can submit only one bid at any one auction.

4. The auctions will be managed and administered by a Foreign Exchange Auction Committee, composed of the Minister of Finance, the Minister of Commerce, the Governor of the Central Bank of Somalia, the President of the Somali Development Bank, and the President of the Commercial and Savings Bank, or their representatives. The Central Bank, jointly with representatives from the Ministry of Commerce, and the Ministry of Finance, shall be responsible for the administration of the auction and for keeping the records of the Committee.

5. Any individual, private enterprise or public enterprise wishing to sell foreign exchange at the auction will be free to do so. Offers for sale, stating name, address and amount offered, without any reserve price, will be accepted. The foreign exchange must be deposited with the Central Bank in a mode satisfactory to the Central Bank, at least three business days prior to the auction day. The exchange rate applicable to such sale will be the weighted average rate of successful bids. Amounts offered in this way will be sold first, that is, ahead of officially supplied foreign exchange. In the event that private amounts are not sold owing to lack of sufficient demand, they will be returned to the depositor beginning on the business day following the auction day.

6. The Central Bank of Somalia will accept bids for the auction in minimum amounts of US $5,000 and maximum amounts of US $200,000. There will be no reserve price or ceiling price predetermined or imposed on the outcome of the auction. Bids must state the name of the bidder, the US dollar amount requested, and the exchange rate (So. Sh. per US $) the bidder is prepared to pay.

   Each bid must be accompanied by a deposit in the form of a Commercial and Savings Bank draft certified by an official of, and designated by, the head office of the Commercial and Savings Bank, amounting to at least one half of the Somali Shilling equivalent of the bid.

   Both the bid and the deposit shall be handed over in a sealed envelope to the Secretariat of the Foreign Exchange Auction Committee, located at the Foreign Relations Department of the Central Bank, beginning at 7:30 a.m. two days prior to the auction day and no later than 11:30 a.m. on the auction day. Under no circumstances will bids be accepted after that deadline. The bid envelopes will be numbered in order of presentation and the bidder will get a receipt bearing that number. The sealed bid envelopes will be scored until the appointed opening time. If at the time of opening of the bids, the deposit is found to total less than one half of the amount bid, the bid shall be declared ineligible.

7. All bids will be opened in the presence of the Foreign Exchange Auction Committee, and representatives of the donors and agencies concerned, beginning at 12:00 noon on the auction day. Bids will be ranked by descending size of the offered exchange rate (So. Sh. per US dollar). Bids offering the same exchange rate shall be ranked according to the sequence of their registration. Following their ranking, all bids within the amount available for sale will be declared successful. If the last bid in the ranking can not be fully satisfied within the amount available for sale, the bidder shall be entitled to buy the remaining amount available.

8. Should the amount of foreign exchange available for the auction exceed the total amount bid, the corresponding funds will be returned to the auction pool.

9. The results of the auction (but not the names of the individual bidders) shall be released by the Central Bank on the auction day for publication.

10. Unsuccessful bidders will have their Somali Shilling deposit checks returned to them without interest at the Foreign Relations Department of the Central Bank during business hours commencing on the day following the auction day.

11. Successful bidders must deposit the full Somali Shilling countervalue of the dollars alloted, calculated at the exchange rate the individual bidder had offered, in a special account in the name of the Ministry of Finance at the Central Bank of Somalia no later than 11:30 a.m. on the third business day following the auction day. If the amount is not deposited within the above time, the bid shall become void and the corresponding foreign exchange shall be returned to the auction pool, and the bidder will be assessed a penalty which shall consist of the difference between half of the amount bid, calculated at the rate offered, and half of the amount bid calculated at the lowest successful bid rate.

12. Successful bidders will have the right to use the acquired US dollars for opening import letters of credit at any time within 45 calendar days after the auction day. Letters of credit financed through the auction shall not be opened by the Commercial and Savings Bank prior to verification by the Ministry of Commerce and the appropriate World Bank funded unit (the "Procurement Unit" at the Ministry of Finance) that the item to be purchased is not on the negative list (see annex) and that the price is within a broad competitive range. Except under certain defined circumstances, the procurement unit will require at least three quotations before approving a letter of credit for imports valued at more than US $200,000, even if only a portion of that amount is to be financed through auction funds. Should a bidder fail to open an import letter of credit within the above specified time, the foreign exchange will automatically revert to the auction pool, and the Somali Shilling countervalue (So. Sh. per US dollar), calculated at the rate originally offered or at the weighted average rate of successful bids in the first auction after the expiration of the 45 day period, whichever is lower, will be returned to the bidder. Subject to the above time limit, a bidder who is successful in more than one auction may cumulate the corresponding US dollars for the purpose of financing import letters of credit.

13. The amount of foreign exchange made available by donors for each auction will be determined by agreement in writing. No more than the amount agreed upon by the donors, plus any foreign exchange contributed by the Government of Somalia and private or public parties, shall be offered at each auction.

14. Any or all of the above procedures ~~and~~ including the contents of the "negative list", attached, are subject to amendment by agreement of the donors and the Government of Somalia.

Imports of any commodity from a World Bank member State, plus Switzerland and Taiwan, are eligible to be financed by funds obtained through the auctions, except commodities on the following negative list:

Arms, munition, military equipment, and goods, diagrams or documents intended for a military or para-military purpose;

Narcotic drugs or any other material dangerous to health;

Books, prints or other material of offending character to, or endangering religion, morals or the democratic constitution of the Somali Democratic Republic;

Alcohol and alcoholic beverages;

Tobacco and tobacco manufactures;

Explosives;

Pearls, precious and semi-precious stones, gold, silver, platinum, jewellery, and goldsmiths and silversmiths wares (except watches and watch cases);

Minerals including uranium, thorium and related alloys, articles, and waste products;

Nuclear reactors and parts thereof;

Goods for private or public luxury consumption.

Procedures For Deposits of Foreign Exchange

Foreign exchange to be made available by the United States Government, and the World Bank, and the Government of Somalia through the auction system shall be deposited in accounts at Citibank in New York, segregated by donor. The procedures to be used for controlling funds and confirming letters of credit shall be as follows:

Citibank, in acting as confirming bank for letters of credit opened in connection with the Government of Somalia auction system, will do the following:

1. For book-keeping purposes, Citibank shall maintain individual sub-accounts into which funds from each donor for the Government of Somalia auction system will be disbursed (i.e., one account each for USAID and the Government of Somalia, and two accounts for the World Bank).

2. Citibank will confirm only letters of credit, supported by donor funds, certified by the World Bank's procurement unit in Mogadishu as eligible under the auction rules (eg. type of commodity, acceptable source/origin). Sufficient funds shall be on deposit with Citibank, New York, before Citibank confirms specific letters of credit.

3. At the time when documents are negotiated for a particular letter of credit, the amount of the drawing shall be identified, and this exact amount of funds will be transferred from the donor sub-accounts into one main concentration account. Payment will be effected to beneficiaries by a direct (automatic) debit to this concentration account. In effecting payments to beneficiaries, Citibank shall transfer the necessary funds from donor accounts at its discretion (ie. there will not be a set, proportionate formula of donor contribution to beneficiary payment, provided that: (1) there will, however, be funds from more than one donor in the concentration account at any one time, and (2) funds will not be transferred from any one donor's account to the concentration account in the exact amount of a letter of credit.

4. Periodically, an aggregate reconciliation report shall be provided by Citibank to any/all parties who so request. This report will capture all information pertinent to the issuance and payment of letters of credit under the Somalia auction system, and shall not give reference to individual donor contributions (i.e., individual letters of credit will not be assigned to any individual donor's account).

Annex B. EVALUATION OF AUCTIONS--IMPACT OF AUCTIONS ON THE FREE MARKET

A. Overview of FY 86 Program

As a result of the success of donor auctions as a mechanism for allocating foreign exchange for imports on a market-determined, non-political basis, the GSDR and IMF have concurred on an expanded version of the present donor auction system as the mechanism for determining the exchange rate under unification. USAID was the first donor to decide that auctions were a good and viable mechanism for channeling balance of payments assistance to the private sector, though we were not the first to institute auctions.

Our FY86 ESF Program provided for a second tranche of $11.011 million, given to the private sector through a cash auction. (A first tranche of $10 million went to the public sector in cash for priority public sector needs.) This decision was made to balance the public sector's urgent need for cash with USAID's belief that the private sector is crucial for development, our belief that a market-determined mechanism for allocating the ESF foreign exchange to the private sector should be examined, and our desire to support the GSDR expiriment with a free market by auctioning funds. The GSDR met all the CP's for the second tranche disbursement and all the requirements for USAID participation in a cash auction in mid-February, 1987.

As a result of USAID's support of the free market and our proposed use of an auction mechanism for allocating funds to the private sector, the World Bank decided to change its AIP II Program and allocate a large percentage of the Program for a donor cash auction: $25 million for the first year. Because of differences in regulations, it was impossible to begin auctions quickly under regulations acceptable to both donors. The major difficulty was A.I.D.'s need at that time to commingle funds sold at auction for imports unless source-origin regulations for CIPs were met. This was impossible. As a result, the World Bank began auctions September 1, 1986, and held auctions bi-monthly thereafter, with one auction- the one in mid-Januaury, 1987- suspended by the GSDR. In February the Italian Government also began to place a portion of its 1986 funds into the Donor Auction: $400,000 each auction. By February 19, the GSDR met all requirements for the disbursement of the second tranche and for USAID participation in auctions. The FY86 ESF program is now funding a portion of all letters of credit beginning with the February 3 auction. We have been matching World Bank/IDA funds on an approximate ratio of two A.I.D. dollars for every World Bank/IDA dollar. (None of the letters of credit for the February 3 auction were verified by Citibank prior to deposit of our funds on February 19, and we were therefore able to fund up to two thirds of the entire auction February 3 auction.)

B. Description and Evaluation of Auctions

ANNEX A gives a description of the cash auction regulations as they applied for our FY86 ESF Program. It provides the regulations as approved by the GSDR in satisfaction of Conditions Precedent for USAID entry into auctions and states the regulations as they have been announced to the public. The following describes the transition to the present system and gives more detail on some points. To some extent, it duplicates portions of ANNEX B1 to avoid the necessity of reading the two Annexes side-by-side. Table A gives a summary of auction statistics through May 17. It provides a reference for discussion in the text below and more detailed information.

- 1. Summary and Auction Mechanics:

Auctions have taken place twice monthly. Under donor auctions, the volume to be auctioned has been announced three business days prior to each auction, and bidders may submit their bids any time from then to the morning of the auction. Names are not listed on bids or when results are announced. Rather, each bid is identified by number according to the order of submission. Each bid must be accompanied by a circular or certified check for half the shilling amount of the total bid. The procedure used for issuing checks makes it unnecessary for the bidder to receive a receipt. Similarly, it means that deposits of unsuccessful bidders may be returned within one day of the auction. To our knowledge, there have never been any complaints concerning improper use of deposits or delays in returning deposits to unsuccessful bidders. Payment by successful bidders of remaining shillings is made to the Central Bank within three days of the auction. This, too, runs smoothly. Any individual, private company, or parastatal (except the National Petroleum Agency) may submit a bid. The GSDR, its Ministries, and Agencies are not allowed to participate. These procedures are expected to continue unchanged - or with only moderate change - under a unified auction.

The Somali business community was told in May, 1986, that donor auctions were contemplated. By mid-August, the public was certain that auctions would begin soon, despite USAID-World Bank inability to concur on joint procedures. By August, the World Bank decided to begin auctions alone and modify procedures later, if possible, to allow USAID participation. The volume of foreign exchange to be supplied each auction had been negotiated by the World Bank, IMF, and GSDR in July. The World Bank formulated final auction procedures the last week in August, with only sufficient time to announce the procedures and auction volume the required three business days prior to the September 1, 1986 auction. Auctions continued twice a month until after the January 3 auction.

The mid-January auction was cancelled on short notice because World Bank funds were being exhausted and the Minister of Finance wanted to suspend auctions until USAID and the Italians could participate. When the Minister and other GSDR officials left for Washington and Rome the second half of January, no information was given the public concerning the anticipated date for resumption of auctions. The Minister returned the end of January, and auctions resumed February 3, with a greater volume o foreign exchange offerred. (see below)

Auction funds may only be used for opening letters of credit for imports. Consequently, unlike funds in normal import accounts, persons may not resell the foreign exchange to another individual. The GSDR and IMF expect to continue these procedures under a unified auction, cease allowing trading among existing import and export promotion accounts, an(forbid the opening of new accounts. Under the donor auction system, the letter of credit must be opened within 45 days of the auction. Funds ma) be accumulated from several auctions during that period and/or augmented with funds from import accounts. If a successful auction bidder decides not to open a letter of credit within 45 days, he/she loses a portion of the shilling deposit as a penalty. Similarly, a person may change his mind after opening the letter of credit, but the shilling penalty still applies. The foreign exchange is returned to the account of the donor. Given the lack of import account foreign exchange with which to augment auction foreign exchange, the 45 day limit may need to be lengthened under the expanded, unified auction.

At present, persons holding funds in regular import accounts can change their minds concerning goods they desire to import. There are some, though minimal, restrictions on imports made with auction funds. In addition to items which private individuals may not import under any circumstances, e.g., military equipment, auction funds may not be used to import luxury goods. Initially, materials for urban construction were prohibited but have been allowed for any letters of credit opened since October. Recently, the GSDR has banned some importation under import-account financed importation, such as small cars. The attempt is to ban luxury goods and goods competing with certain domestic industries. The list will need to be examined and studied to see if the restrictions help or hurt the economy. (Protection of potentially viable infant industry may be justified. Protection of non-viable, cooperative or parastatal industry probably is not. This will undoubtedly be examined under an evaluation of the auction.)

- 2. Determination of Successful Bidders:

All bids are arranged in descending order. When more than one bid is for the same amount, the bids are ranked in the order of submission. Thus, the earlier one submits a bid, the greater the chance of being successful. This procedure is expected to continue. It works well, not only allowing a mechanism for determining winners when several bids appear at the same rate, but it encourages fractional bidding, which discourages collusive bidding. (Receiving a fraction of the funds requested is not a viable alternative for someone requiring a certain amount of foreign exchange to make importation possible.)

The original agreement called for marginal pricing, e.g., all bidders paid the bid of the lowest successful bidder. (This is similar to pricing at the intersection of supply and demand curves.) After the third auction, the GSDR convinced the IMF and World Bank to allow a Dutch Auction, whereby each successful bidder pays what he or she bids. The GSDR requested this in an effort to lower all bids. The action certainly had the desired effect initially. (See Table A)

- 3. Volume Auctioned:

World Bank and IMF teams from Washington negotiated with the GSDR in the summer of 1986 to place $2.3 million of World Bank funds in each of the first three auctions, with funding dropping to $1.9 million thereafter. (Comment: This rate of disbursement was too high for the first tranche of World Bank funds to last until the second tranche was available. Funding from other donors, with a concomitant reduction in World Bank funding was essential for maintaining auctions. Despite the high level of disbursement for World Bank funds, the Bank intended for auctions to continue until the second tranche of funds was available. The lower, World Bank level if other donors entered was also too high to allow funds to last.) Initial feeling among donors in Mogadishu was that $2.3 million was too large a volume. The volume was a compromise between donor desires for a volume of $1.5 to $1.9 million per auction and the GSDR desire for $5 to $10 million per auction.

During the IBRD annual meetings in Washington in late September, the delegation from Somalia met with the World Bank and IMF to discuss auction procedures. Despite the rapid rate of exhaustion of World Bank funding, the obvious inability of USAID to participate for some time, and World Bank and Fund concern over the low auction rate, the GSDR convinced the IMF and World Bank to continue with the $2.3 million level for at least two more auctions, with the potential of increasing the volume to $2.9 million if other donors placed funds in the auction. (At this stage, the World Bank indicated an inability to alter auction procedures to allow USAID participation.) It was at this point that the GSDR also convinced the World Bank and IMF to shift from a system of marginal pricing to a Dutch auction. Despite a strong preference for marginal pricing, the IMF agreed to the Dutch auction system.

After the fifth auction, the IMF in Washington became concerned over the low bid rate (shown in Table A and discussed below). Realizing the volume auctioned was too high, the IMF and World Bank reduced the amount of World Bank funding to $1.9 million. Just prior to the sixth (November 17) auction, however, the GSDR announced it was placing $400 thousand of its own resources in the auction to maintain the $2.3 million level. Despite IMF and World Bank objections to this use of essentially unavailable funds, the GSDR again augmented the seventh auction by $400 thousand. In the eighth auction, the GSDR finally realized it had higher priorities for its foreign exchange and left the volume at $1.9 million. The eighth and ninth auctions had only $1.9 million each.

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There was a suspension of auctions in mid-January when GSDR officials went to Washington and Rome to try to ensure that A.I.D. and Italian participation in auctions began before World Bank funds were exhausted. Although no date was set for resumption of auctions, the Minister of Finance returned to Mogadishu the very end of January and on February 1 announced an auction of U.S. Dols 2.9 million for February 3. Although this volume exceeded a telex from the World Bank sent while the Minister was out of Somalia, the volume corresponded to the level indicated as acceptable by a World Bank official in Washington. By the February 17 (eleventh) auction, the Minister of Finance reluctantly agreed to the newly set World Bank limit of U.S. Dols 2.4 million per auction and subsequently obtained IMF concurrence on alternating volume between 2.9 and 2.4 until review of auction procedures or an end to the first tranche of World Bank funds, whichever cames first. Occasionally, private sector companies and organizations not eligible to use the free market but eligible for the auction have placed funds in the auction. Until May 17, when the Central Bank Governor and IMF Resident Representative decided to remove these funds from the auction but allow the companies/organizations to sell the shillings to the Central Bank at the May 17 auction rate, these funds added to the agreed limit of $2.4 million or $2.9 million, rather than replacing donor funds.

- 4. Auction Bid Rates:

In examining auction bidding, auctions can essentially be separated into two groups, with the first group having two sub-groups. The first group contains the period during which only the World Bank participated. This can further be divided into the period before the Dutch auction system began and the period after. The second group of auctions contains those following the mid-January suspension and the subsequent resumption of auctions with USAID and Italian participation.

There was considerable concern prior to the first auction that a lack of understanding of auctions, hesitancy to participate initially, rumors of Government desire for low bids, or complete lack of knowledge of the actual existence of auctions would result in a sufficiently large number of bids lower than the official rate that the auction rate would be lower than the official rate. There was also the possibility, increased with the short notice given for the first auction, that the volume of foreign exchange requested would be less than the amount offered, and the lowest bid, however ridiculous, would set the rate. The GSDR, IMF, and World Bank, however, preferred not to set a minimum or floor rate for fear the public would interpret it as the quote auction rate unquote.

Fortunately, the number of bidders (100) was relatively large, and the volume of foreign exchange requested was among the highest of all auctions: U.S. dols 8.5 million according to a USAID observer present at the auction and recording summary information as it was announced; U.S. Dols 6.5 million according to information presently being released by the Central Bank. The public had been anticipating auctions for sufficiently long and had lowered free market purchases in anticipation of auctions. In addition, export proceeds from the Haj did not begin appearing on the free market until late September. Bidding for the first auction was higher than anticipated, though sufficiently lower than the free market rate to give winners a windfall gain. The number of "extremely low" bids was substantial. Twelve percent of all bidders bid below the official rate, which was then SoSh 78 equals U.S. Dols one, but which devalued to 82 a few days later. The median bid was 90. The lowest successful bid, however, was 110, and this was therefore the rate paid by all successful bidders. The estimated import account rate for the period immediately preceding the auction was approximately 128, making the ratio of the amount paid by successful bidders 85 percent of the import account rate. (see last line on Table B1)

By the second auction, the lowest successful bid, and the amount paid by all successful bidders, was 100. There were rumors, unconfirmed, that members of the government discouraged persons from bidding above 100. Whatever the reason, for both the second and third auction, 30 percent and 41 percent of the bidders respectively bid exactly 100. Less than half of them were successful, given the regulations for determining winners by order of bid submission when there are more bids at the lowest successful rate than foreign exchange. Bidders had either not yet learned to bid at fractional levels, e.g., 100.1, or felt political pressure to avoid bidding above 100.

Despite the assumption that people were being discouraged from bidding above SoSh 100 or from high bids in general, bidding overall (basically mean, median, and mode) was higher than for the first auction, with only two persons bidding below the official rate in each auction, and with increases in the highest bid, the mean bid rate of all bids, and the median bid. Only the weighted mean of successful bids dropped from the first auction to the second and third. Despite the lower auction rate (100), the GSDR still felt that the auction rate was too high and was concerned over the general increase in bids. (Government officials talked seriously at this time of using the auction rate as the rate for exchange rate unification and wanted a rate no higher than 100 and hopefully lower. The official rate after the third auction was only 86.)

The Dutch auction began Oct. 16, and the initial impact was exactly as the GSDR would have wished. Virtually all bidders lowered their bids. Although the total amount of foreign exchange requested was less than for the second (Sept. 16) auction and the number of eligible bids was less than for the first auction though somewhat above the second and third (see Table A), the Somali Shilling rate for the lowest successful bid dropped from 100 to 92. In addition, even using a Dutch auction system where each successful bidder pays what he bids, the average amount of shillings per dollar received by the GSDR dropped slightly from the marginal rate of 100 for the third auction to the "weighted mean of successful bids" -- the method of determining the average shilling per dollar with a dutch auction-- of 99.8. For the fifth (Nov. 1) auction, the lowest successful bid rose slightly to 94, but the weighted mean of

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successful bids dropped to 96.5 as persons realized the disadvantages of paying more than other bidders for the exact same dollars. Beginning with the fourth auction, persons began realizing the benefits of bidding in fractional amounts, i.e. 105.1 rather than 105, given the method of determining successful bidders when too much foreign exchange was requested at the lowest successful rate than was available. The use of bid order in quote breaking ties unquote and the gradual understanding of the system by the Somalis may be partially responsible for the gradual increase in rates.

As indicated by Table B1, from the fifth through the ninth auctions the lowest successful bid, highest bid, weighted mean of successful and all bids, median bid, and mode all moved steadily upward. There was an initial tendency for bids to cluster just above the lowest successful bid of the preceding auction, as bidders tried to win, without paying more than other bidders. E.g., for the fifth auction, there were several bids at exactly 93, one shilling above the lowest successful bid of the fourth auction and one shilling below the lowest successful bid of the fifth auction. This strategy continually proved unsuccessful. Auction foreign exchange at that stage was a bargain compared with the free market, even adjusting for the additional restrictions on its use. Despite the interjection of Central Bank funds into the sixth and seventh auctions to keep the level at 2.3 million, by the seventh auction a pattern emerged whereby the lowest successful bid tended to be at about the level of the highest bid of the preceding auction, and all averages continued to rise through the January 3 (ninth) auction. By then, the auction rate was 90 percent of the free market rate for imports-- probably close to equalling the free market after adjusting for auction restrictions. Consequently, the auction rate would probably have stabilized had auctions continued uninterupted..

The suspension of auctions in mid-January altered trends. Because of some confusion in the private sector concerning reasons for the brief suspension of auctions, questions over the future of the auction system, the short notice given for the February 3 auction, and a rather sizable increase in the of funding, the pattern of auctions from February 3 through March 1 did not follow the trends. from early October through the Janaury 1 auction. When auctions resumed, the rate of the lowest successful bid dropped from 121 to 115. This is partially attributable, however, to the increased volume. Had the volume remained at $1.9 million, the lowest successful bid would have been 125, one shilling below the highest bid of the previous auction. (Had the level of funding been $2.4 million-- the World Bank approved level-- the lowest successful bid would have been only 116.)

With the suspension of auctions and uncertainties concerning the future of auctions, bidders were not sure what to expect. The highest bid was 136, considerably above the 126 of the previous auction and indicating many persons assumed the previous trends would continue. Unfortunately, the decrease in the lowest successful bid appears to have had a

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psychological impact, and 115 was the rate for the lowest successful bid for all three auctions starting with February 3. Beginning with March 1, however, there were indications that the trends of last fall would begin again. For the March 1 auction, only one of the seven persons bidding 115 was successful and he received only eight thousand dollars of the 200,000 requested.

Beginning with March 16 and continuing through May 17, people became familiar with the auction again, and the bidding patterns of late fall emerged. Bidders began to realize that the majority of persons bidding at exactly the winning bid of the previous auction did not win. The seasonal drop in export proceeds may have had some impact, and business recognition that auctions might not continue may also have contributed to higher bidding. Certainly, the large volume of foreign exchange requested for the April auctions and May e auction may have resulted from fear that these might each be the last auction and that the second tranche of World Bank funding might not be available. The volume requested for the May 17 auction dropped, however, and the rates continued to rise. Indeed, despite the increase in the free market rate, the auction rate as a percentage of the free market rate rose to over 90%. In addition, there will most likely be a hiatus in auctions.

- 5. Impact of Auction Volume:

Auction volume initially was critical to determining price. This is true despite the fact that recently there has been little impact with the alternating between $2.4 million and $2.9 million. The small number and percentage of winners would have been altered little had the volume been $2.9 million rather than $2.4 million. (The small impact may indicate the benefits and necessity of the public having fairly assured and advanced knowledge, however, and the relative stability of the alternation.)

Unfortunately, there is no scientific method for determining the "correct" volume. The GSDR would like auctions to provide as much foreign exchange as is requested, however low the bid price. In some respects, we can use the free market as a guide for determining the "market rate." We will not be able to use it as a guide under a unified system, however, and the black-market rate in Jidda would not serve the same function since it would be used more for capital flight.

Although we consider the free market to be well run and, since September, to be relatively free of speculation, the volume of foreign exchange transacted in import accounts is extremely slight. The total volume of foreign exchange sold in all accounts per month is less than the amount sold at auction, even allowing for possible inaccuracies in the data given us. Many persons keep their own foreign exchange for personal use. Thus, the free market rate is only a guide, and we will soon lose that as a method of determining the volume of foreign exchange needed for auction.

It is not possible to meet all Somalia's needs for foreign exchange. We believe wide fluctuations in the amount of foreign exchange offered per auction (or wide fluctuations in the combination of the free market and auction) are detrimental and lead to swings in the market. Therefore, we consider the best method of determining the "correct" amount of foreign exchange to provide per auction is to determine the total amount of foreign exchange available for auctions and the length of time the funds need to last, either until new funding sources are available or auctions are no longer needed. The amount per auction is thus determined, with perhaps modifications for seasonal variations in other sources of foreign exchange or seasonal variations in demand for foreign exchange. This approach approximates a market mechanism more closely, anyway.

\- 6. Relationship of Auction Rate to Free Market Rate

Basically, the auction rate as a percentage of the import account rate on the free market rose steadily until it reached 90 percent for the January 3 auction. The suspension of auctions caused considerable uncertainty and some devaluation of the free market. With devaluation of the free market and the drop in the weighted mean of successful bids for February 17 and March 1, the auction rate as a percentage of the free market dropped to around 83 percent, the level it had been in the December 16 (eighth) auction. (Although the weighted mean of successful bids was higher for February 3 than for February 17 and March 1, the applicable free market rate for import accounts dropped from about 149 for the February 3 auction to 145 for the other two.

Despite the rise in the auction rate following the March 16 auction, the rise in the free market rate kept the ratio of the two below 85%. In the last two auctions, however, the rate has risen to 87% for the May 2 auction and 91% for the May 17 auction. This is especially noteworthy since the free market rate has also risen during that time. Data on the ratio of the auction rate to the free market rate for import accounts is given on the last two lines of Table B1. The free market rate used is the rate for import accounts for the period preceding the auction. Information provided by the Commercial Bank often includes transactions that are not truly quote freely determined unquote. For consistency with information distributed by the GSDR concerning the auction, we are using IMF estimates for the import account rate rather than data collected ourselves. (There are only slight differences.) The Commercial Bank did not begin keeping separate records on exchange rates for the three types of free market accounts until mid-September. Consequently, the import-account rate for the first two auctions is estimated.

The second to the last line on Table B1 gives the ratio of the mean rate of successful bidders to the import account rate. For all auctions since the introduction of the Dutch auction system October 16, this represents the average number of shillings per dollar of foreign exchange provided by the auction. The ratio does not represent the same thing for the first three auctions, however, since all successful bidders paid the bid rate of the lowest successful bidder. Consequently, the last line is included for the first three auctions. For all succeeding auctions, the ratio would be identical with the number on the second to last row.

C. IMPACT OF AUCTIONS ON THE FREE MARKET

Given gaps in data and consequent difficulty in separating causation from correlation, no definitive conclusions can be reached at this time concerning the impact of auctions. Information can be gathered, however, concerning the relationship between the announcement of auctions, the auctions themselves, and activity on the free market. The auctions certainly appear to have had the desired intent of stopping speculation. Except for a slight rise the end of June, the free-market rate essentially stopped devaluing from May, when the World Bank announced its intention to auction foreign exchange to the private sector, through July. The rate began appreciating in August following a GSDR announcement the beginning of August that auctions would definitely begin that month. Indeed, the Somali shilling revalued upward from between SoSh 155 and 157 per dollar in late July to a rate of SoSh 122 to the dollar for a brief period toward the end of August. This represents an appreciation of over 20 percent.

When auctions actually began, the shilling devalued somewhat as the amount auctioned was less than had been rumored. There were fluctuations during September as the public adjusted to auctions. From mid to late September until the first half of January when the public learned auctions would be suspended, the import account rate remained around 135, with very little change. There were only slight, temporary fluctuations in the nominal rate from September through December. Adjusted for inflation, the shilling value in December 1986 was almost identical to that of January 1986. See Graph 5 and Table 14 in the main text. The shilling began devaluing the second week of January, 1987, with the import account rate temporarily rising to 150 and then dropping slightly. The devaluation appears to have been the result of the GSDR announcement that the auctions would be suspended until further notice. The auctions resumed February 3, and the free market rate appreciated almost to the early January level. This occurred only briefly, however. Since then, the free market has continued to devalue, and import account foreign exchange is now between SoSh 155 and 165 = $1. In March, average rate for all accounts was at about the level it was last June. Adjusted for inflation, however, the value of the shilling is still greater now than a year ago. In addition, present devaluation can be attributed to a number of factors: adjustment for inflation; seasonal shortage of export proceeds; public awareness that unification will occur and the free market will probably be closed; lack of complete knowledge on the part of the public concerning the proposed changes and their probably impact; and knowledge that there may be a hiatus between donor-auctions and the new unified system since donor funds are becoming exhausted and new agreements may not follow immediately.

D. Conclusion: The auctions have increased public access to foreign exchange for importation. The success of the suctions has also resulted in an additional option being offered the GSDR for exchange rate unification. As a result, there is strong indication that the auctions have played a role in preventing unification in December, 1986, at an over-valued rate, or without a proper method of keeping the rate realistic. Although the auction rate provided somewhat overvalued foreign exchange at the beginning and for a period when auctions resumed in February, the ratio of the auction rate to the free market rate for the ninth auction on Jan. 3, was .90. For the May 2 and May 17 auction, it was .87 and .91 respectively, despite some evidence that the free market may have some speculative pressure due to potential closing of mechanisms for unrestricted export of foreign exchange out of the country. Given the restrictions on use of auction funds, including the fact the auction winner cannot resell the foreign exchange, this ratio does not offer excessive profit to successful bidders.

Several areas still need to be examined. The small volume of transactions from import and export promotion accounts decreases conficence in using those exchange rates as an indication of market-determined rates. The problem of determing how "market determined" the auction rate is will increase when unification occurs, and simply adjusting for purchasing power parity among major trading partners, which we intend to do, will not give a complete answer.

The public appears now to have no fears about participating in auctions, but the suspension of auctions without adequate information provided created uncertainty. We do not know what type of impact there may be if there is a large and uncertain gap between the present auctions and unification.

An area of concern is the Government desire for both a low auction rate and a volume of foreign exchange that provides funding for everyone requesting currency. Fortunately, the GSDR has only placed its own resources into the auction twice. It exceeded the World Bank ceiling an additional time (February 3), but that action may have resulted from a genuine mis-understanding. Nevertheless, we do not believe the volume of funding per auction is a decision which should be left solely to GSDR officials. Regarding general auction procedures, they work remarkably well. There have been no reports of delays or the need for bribes to get deposits returned, hasten opening of letters of credit, ensure the GSDR approves a letter of credit for a commodity already on the eligible list, or accept a bid. There are absolutely no attempts to alter the bids after submission or to give funds to someone slightly below the cut-off point. The efficiency and honesty shown in conducting auctions are remarkable.

Table B1 COMPARISON OF CASH AUCTION RESULTS

				Beginning of Dutch Auction					
Auction Number	1	2	3	4	5	6	7	8 (1)	9
Date	Sept. 1	Sept. 16	Oct. 1	Oct. 16	Nov. 1	Nov. 17	Dec. 1	Dec. 16	Jan. 3
Volume of FX offered	$2,300	$2,313	$2,300	$2,300	$2,300	$2,300	$2,300	$1,900	$1,906
Volume of FX Requested	$6,531	$4,683	$4,231	$4,530	$4,659	$5,916	$8,451	$8,100	$5,592
(Vol. requested at bids above the official rate)	$5,597	$4,283	$3,974	$3,850	$3,049	$5,736	$8,451	$7,551	$5,592
No. of eligible bids	100	69	73	85	82	93	118	109	91
(No. above official rate)	88	67	71	74	76	89	118	109	91
(No. below official rate)	12	2	2	11	6	4	0	0	0
No. of successful bids	22	39	34	49	32	32	20	25	20
Highest Bid rate (3)	122	150/127	135	112	101	105	110.1	120	126
Lowest Successful Bid Rate (4)	110	100	100	92	94	97	105	111.5	121
Lowest Bid Rate (5)	20	60	80	50	82	90	95	100	96
Weighted Mean rate of Successful Bids	117.1	111.2	106.8	99.8	96.5	99.9	105.5	113.3	122.3
No. of "small" successful Bids	8	25	19	35	16	19	3	11	7
Small successful bids as % of successful bids	36%	64%	56%	71%	50%	59%	15%	44%	35%
Mean Bid Rate	96.3	104.5	100.7	94.4	92.0	96.2	101.0	109.3	116.7
Median Bid Rate	90	100	100	95	92	96	100	110	117.1
Mode(s)	100/120	100/120	100	90/100	95/90	96	100	110	115/120
Range	102	90	55	62	19	15	15.1	20	30
Mean amount bid	65.3	67.9	58.0	53.3	56.8	63.6	71.6	74.3	61.5
Mean amount of successful bids	104.5	59.3	67.6	46.9	71.9	71.9	115.0	76.0	95.3
Mean Rate of Successful Bids/Import Account rate	0.91	0.82	0.81	0.73	0.73	0.75	0.78	0.83	0.90
Shillings paid be Successful Bidders/Import Account Rate (prior to Dutch Auction)	0.89	0.74	0.76						

TABLE B1 (CONT.)

Auction Number Date	10 Feb. 3	11 Feb. 17	12 (2) Mar. 1	13 Mar. 16	14 April 1	15 April 16	16 May 2	17 May 17
Volume of FX offered	$2,900	$2,400	$2,930	$2,420	$2,936	$2,440	$2,900	$2,400
Volume of FX Requested	$4,630	$4,785	$4,427	$6,386	$7,995	$8,757	$9,005	$5,123
(Vol. requested at bids above the official rate)	$4,610	$4,785	$4,127	$6,386	$7,795	$8,757	$9,005	$5,123
No. of eligible bids	71	77	69	81	104	107	114	80
(No. above official rate)	70	77	67	81	103	107	114	80
(No. below official rate)	1	0	2	0	1(6)	0	0	0
No. of successful bids	51	36	44	27	32	23	36	30
Highest Bid rate (3)	136	130.5	125.2	125/121	127	132.51	142	150
Lowest Successful Bid Rate (4)	115	115	115	121.5	121.5	127	133.1	141.1
Lowest Bid Rate (5)	20/100	100	40/60/100	100	1/110	102/120	115	120
Weighted Mean rate of Successful Bids	125.4	119.8	118.7	119.5	123.17	128.6	135	144.5
No. of "small" successful Bids	32	22	23	12	15	7	17	16
Small successful bids as % of successful bids	63%	61%	52%	44%	47%	30%	47%	53%
Mean Bid Rate	119.2	113.2	114.2	116.9	122.38	125.3	131.9	139.9
Median Bid Rate	125	115	116.5	117	121	125.1	132	140
Mode(s)	125	116	115	116	120	125	130	140
Range	116/36	30.5	85.2	25	126	30	27	30
					(17)2			
Mean amount bid	65.2	62.1	64.2	78.8	92.6	81.8	79	64.8
Mean amount of successful bids	56.9	66.7	66.6	91.7	93.6	108.4	81.7	85.2
Mean Rate of Successful Bids/Import Account rate	0.84	0.83	0.82	0.81	0.82	0.85	0.87	0.91
Shillings paid be Successful Bidders/Import Account Rate (prior to Dutch Auction)								

(1) Actual records taken at the December 16 auction show the volume auctioned to be $8.1 million. Present IMF statistics show $7.551. We believe $8.1 is more correct. For the first auction, a USAID staff member present indicated that the volume requested was approximately $8.5 million. We were given the same figure unofficially by GSDR officials. Given the carefulness with which auctions are conducted, that figure is as likely to be correct as the $6.531 M volume presently provided.

(2) Occasionally auctions include small amounts from outside sources. For March 3, a private company provided $30,000.

(3) When two numbers appear as the "highest" bid, the second number represents the second highest bid. The second highest bid is to indicate a large range between the highest and bid and the one immediately following.

(4) Almost 30% of total bidders and over 40% of total bidders bid exactly 100 for the second and third auctions respectively. Less than half were successful at the second auction and between a third anf fourth were successful at the third auction.

(5) When more than one number is given as the lowest bid, it indicates one person bidding at the lowest, and possibly second lowest, a large gap until the next bid.

ANNEX C: DESCRIPTION AND EVALUATION OF IMPORTS UNDER AUCTIONS, THE FREE MARKET, CIPS, AND A FIXED EXCHANGE REGIME

A. Overview:

Under any type of exchange regime, Somalis tend to import tradable goods. True investment goods are eschewed. This results partially from Somalia's history as a trading society. Additionally, medium and long term investment are avoided because of lack of certainty over the future and the quick profit which can be made from trading.

Donors and some GSDR officials have been concerned that the auction rather than traditional CIPs, and the free market in general, might reduce investment still further. Evidence is scanty, partially because most import data do not separate public sector imports, which include machinery, agricultural equipment and other investment type items. In addition, franco valuta inputs (those imported with one's own foreign exchange prior to opening of the free market) are excluded. Real investment does not appear to have been reduced by either the auction or free market, but this cannot be proven.

Initial concern over donor auctions was a fear they would result in large numbers of luxury items imported by the wealthy. There were initial restrictions on luxury imports, though they were never clearly defined, and the limited regulations were not really enforced. A very small percentage of auction funding went for items used primarily by the wealthy.

A recent concern over the donor auctions, extending into the proposed unified auction, has been the large percentage of auction funds going to food and beverages: over 60%. In 1985-- the first year of the free market-- food, beverages, and tobacco accounted for approximately 40% of free market imports. This is higher than the percentage from the auction for just food and beverages. (Tobacco is not an eligible item) Forty eight percent of the commodities financed by the free market from September through December, 1986, was food. Thus, the free market percentage also rose. At the moment, it is not possible to determine whether the increased importation of food with free market foreign exchange represents a trend or a reaction to temporary conditions in the country. (See Table C1 for composition of imports by auction and Table C2 for a comparison of auction versus free market imports for the September to December period, 1986.)

The composition of food imports has varied by auction. Imports of certain types of food tend to cluster by groups of auctions, indicating trader reaction to present market conditions and an indication that free market conditions are working. In some instances, too many persons appear to have imported the same commodities and traders may have taken a loss, further indication of a market system.

B. Commodities From CIPs: There have been a few CIPs and Agricultural Input Programs (AIPs) remaining. Prior to 1986, USAID had a CIP. Donors providing CIPs and AIPs have tried to direct their funds toward "productive" enterprises. In general, consumer goods have been prohibited, which is not true under the free market or auctions. Imports under CIPs and AIPs, however, have rarely been tractors or other machinery. Fertilizer and other agricultural inputs have been common. For industry, some companies have purchased new investment equipment, but raw materials for production from existing capacity, with occasional purchases for spare parts are common. Often, companies continue to have idle capacity and/or let existing investment goods deteriorate rather than purchase even medium-term investment goods under a CIP.

The USAID CIP helped greatly in re-introducing private sector production into Somalia and increasing the confidence of the private sector. This, however, was during a period of fixed, over-valued exchange rates, with foreign exchange allocated by the Central Government. Except for franco valuta and true black market foreign exchange, CIPs provided the only foreign exchange available. In addition, the support of a donor behind the program gave the newly emerging private sector greater confidence that the GSDR would truly allow re-introduction of private business. This, and other innovative measures, have led to some successes from CIPs.

Since the introduction of the free market, CIPs are not viable except at greatly subsidized exchange rates. The 1985 USAID CIP remained unclaimed by the private sector when the CIP rate was SoSh 85 = $1 and the free market rate rose above SoSh 115 = $1. Other donors with fewer restrictions have found similar problems. We would like to see some activities encourage medium- and long-term investment and/or employment generating industries. A traditional CIP does not appear to be the way to do this, however. We do not believe that, in general, we can do a better job than the market place in determining what activities are productive, though we are interested in taking a long-term look at potential areas for selected project assistance. In addition, the types of goods generally purchased under CIPs-- raw materials and spare parts-- are and can be purchased under the auction system and free market.

D. General Imports From Auctions:

The auctions have definitely favored consumer goods over producer goods when compared with private sector imports in 1984 and 1985. Food provided about one-third and producer goods over one-half of private sector imports. Since there was a free market in 1985, the change is not entirely due to GSDR decisions regarding which imports to finance. The increase has been in food, however, which is purchased by a wide range of income groups in Somalia. Almost none of the auction funding has gone for consumption imports used only by the wealthy, such as televisions.

As can be seen from Table C1, there have been fairly wide variations among auctions regarding percentages of various goods. Only a few of these variations are due to changes in auction rules, legally or in practice. Initially, materials for urban residential construction were banned, though given the impossibility of truly knowing the end use of imported construction materials, the Procurement Unit was told to take a liberal view regarding construction. Nevertheless, consumer uncertainty at the beginning of auctions probably explains the lack of any construction inputs financed from the first auction.

Technically, luxury goods have been banned from auctions, and the GSDR was to provide the World Bank with a list of "luxuries." The list was provided after several auctions, and was related more to protection of industries owned by party cooperatives and parastatals than luxuries. E.g., soap, canned meats. In addition, small, but not large cars were banned on the grounds the latter could be used as busses. The list remained in theory, but it was never applied in practice. Its existence, however, may have influenced bidder decisions until they became more familiar with the auction in practice.

Other variations are more difficult to understand such as the purchases of transportation equipment only from the second, eighth, ninth, and eleventh auctions. Another apparently "seasonal" good is textiles and household goods. The percentage has varied greatly by auction.

The variation in food imports is more understandable. Large amounts of sugar were purchased from the first three auctions and none since. Sugar was in short supply during the early stages of the auction, and the low auction rate made the good appear profitable, though the persons bidding in the first auction had no way of knowing what the marginal/auction price would be. A Government parastatal produces sugar, though not truly enough to satisfy demand. The lack of sugar imports since the third auction is probably due at least in part to a drop in the price of sugar, resulting partially from the greatly increased supply, and a loss to importers. Some persons indicate Government "encouragement" to cease importing sugar. Flour became the next large import item, followed by pasta. Rice has been imported, especially from auction 6. Vegetable oil and beverages have also been important. The shifts appear to indicate trader response to market prices. With such large numbers importing the same items at the same time, the increased supply is undoubtedly driving down the price somewhat, and the traders will find their profits are less than anticipated. Eventually, however, they will adjust for this as they realize other traders will be responding to the same signals.

E. Impact on Agriculture:

With the exception of a few auctions, the auction prices approach free market prices. Consequently, the price of consumer food imported under the auction is a market-determined price. Were food excluded from the auction, it would be bought with free-market foreign exchange, as is a large amount of food at present. When food is imported at freely-determined, market prices, it indicates either that consumers prefer a different mix of food than what is produced domestically or that the same domestic food is not competitive, which is presently true for rice. With the possible exception of protecting new, but eventually viable industries, restricting such imports hurts the country more than it helps. Tariffs, quotas, or prohibitions on imports increase the price, in this case to the average Somali. Such actions can also result in permanent subsidies to non-productive industries or agricultural products, something a country with Somalia's budget problems cannot afford.

SOMALIA — Composition of Auction-Financed Imports 1/
(In thousands of U.S.$ and percent)

COMMODITY CATEGORY	Auction 1		Auction 2		Auction 3		Auction 4		Auction 5		Auction 6	
	Value	Percent	Value	Percent	Value	Percent	Value	Percent	Value	Percent	Value	Percent
Food and beverages	2141.5	93.6	1200.0	54.5	959.8	44.1	1012.7	52.1	1592.5	69.8	1259.3	60.7
Wheat flour	563.0	24.6	200.0	9.1	209.0	9.6	297.5	15.3	992.4	43.5	1062.1	51.2
Pasta	132.7	5.8	173.1	7.9	111.3	5.1	22.8	1.2	0.0	0.0	92.7	4.5
Sugar	1385.8	60.5	602.0	27.4	570.6	26.2	0.0	0.0	0.0	0.0	0.0	0.0
Other 2/	60.0	2.6	224.9	10.2	68.9	3.2	692.4	35.6	600.1	26.3	104.5	5.0
Textiles/households	36.9	1.6	154.5	7.0	38.0	1.7	275.4	14.2	45.0	2.0	0.0	0.0
Other consumer goods	20.0	0.9	17.4	0.8	116.5	5.3	25.1	1.3	0.0	0.0	50.2	2.4
Transport equipment	0.0	0.0	29.4	1.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Materials and spares	0.0	0.0	663.1	30.1	859.3	39.4	622.8	32.0	582.2	25.5	521.1	25.1
Construction	0.0	0.0	60.0	2.7	293.6	13.5	107.3	5.5	477.0	20.9	438.2	21.1
Agricultural	0.0	0.0	0.0	0.0	41.2	1.9	79.0	4.1	21.2	0.9	0.0	0.0
Other	0.0	0.0	603.1	27.4	524.5	24.1	436.5	22.4	84.0	3.7	82.9	4.0
Equipment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	26.2	1.1	103.4	5.0
Other commodities	90.3	3.9	135.9	6.2	204.8	9.4	9.0	0.5	34.0	1.5	139.3	6.7
TOTAL	2288.7	100.0	2200.3	100.0	2178.4	100.0	1945.0	100.0	2279.9	100.0	2073.3	100.0
Memorandum items:												
Value of L/Cs not open within 45 days 4/	11.3		112.7		121.6		355.0		20.1		226.7	
Auction amount	2300.0		2313.0		2300.0		2300.0		2300.0		2300.0	

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TABLE C1 (CONT.)

COMMODITY CATEGORY	Auction 7		Auction 8		Auction 9		Auction 10		Auction 11		TOTAL	
	Value	Percent	Value	Percent	Value	Percent	Value	Percent	Value	Percent	Value	Percent
Food and beverages	2316.7	93.9	1277.0	58.3	1267.7	65.0	1060.0	56.1	730.0	79.7	14817.2	66.2
Wheat flour	147.0	6.0	200.0	9.1	175.5	9.0	40.5	2.1	0.0	0.0	3887.0	17.4
Pasta	101.0	4.1	307.9	14.1	109.2	5.6	517.1	27.4	333.6	36.4	1901.4	8.5
Sugar	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	2558.4	11.4
Other 3/	2068.7	83.8	769.1	35.1	983.0	50.4	502.4	26.6	396.4	43.3	6470.4	28.9
Textiles/households	0.0	0.0	0.0	0.0	0.0	0.0	7.0	0.4	0.0	0.0	556.8	2.5
Other consumer goods	0.0	0.0	0.0	0.0	56.0	2.9	78.2	4.1	39.9	4.4	403.3	1.8
Transport equipment	0.0	0.0	200.0	9.1	122.3	6.3	0.0	0.0	40.0	4.4	391.7	1.8
Materials and spares	76.5	3.1	513.5	23.4	293.5	15.0	443.9	23.5	34.6	3.8	4610.5	20.6
Construction	76.5	3.1	124.0	5.7	0.0	0.0	177.2	9.4	28.6	3.1	1782.4	8.0
Agricultural	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	141.4	0.6
Other	0.0	0.0	389.5	17.8	293.5	15.0	266.7	14.1	6.0	0.7	2686.7	12.0
Equipment	75.0	3.0	200.0	9.1	182.2	9.3	157.5	8.3	36.0	3.9	780.3	3.5
Other commodities	0.0	0.0	0.0	0.0	30.0	1.5	141.5	7.5	35.8	3.9	820.6	3.7
TOTAL	2468.2	100.0	2190.5	100.0	1951.7	100.0	1888.1	100.0	916.3	100.0	22380.4	100.0
Memorandum item:												
Value of L/Cs not open within 45 days 4/	-168.2		109.5		-45.7		1011.9		1483.7		3238.6	
Auction amount	2300.0		2300.0		1906.0		2900.0		2400.0		25619.0	

Source of Letter of Credit Data: Ministry of Finance, Procurement Unit.

1/ Forthnightly auctions of foreign exchange from the World Bank's ASAP credit, beginning September 1, 1986.
2/ Partial utilization of funds acquired in auctions from November 1.
3/ Largely rice, vegetable oil, and beverages. Almost all rice from auction 6.
4/ Includes amounts of successful bids for which the SoSh. balance was not paid within the prescribed three days, and small allocated amounts not utilized for the actual L/C's. For auctions 10 and 11, the 45-day period had not expired at the time of compilation of this table.

TABLE C2

SOMALIA -- Comparison of the Composition of Auction-Financed Imports and of Privately-Financed Imports. September-December 1986 1/
(In thousands of US$ and percent)

COMMODITY CATEGORY	Auction		Private		TOTAL	
	Value	Percent	Value	Percent	Value	Percent
Food and beverages	8165.8	63.0	5470.6	47.9	13636.4	55.9
Wheat flour	3324.0	25.6	...	...	...	...
Pasta	532.6	4.1	...	...	...	...
Sugar	2558.4	19.7	...	...	...	...
Other 2/	1750.8	13.5	...	...	...	...
Textiles/households	549.8	4.2	113.8	1.0	663.6	2.7
Other consumer goods	229.2	1.8	...	...	...	...
Transport equipment	29.4	1.3	1335.4	11.7	1364.8	5.6
Materials and spare parts	3248.5	25.1	1947.9	17.1	5196.4	21.3
Construction	1376.1	10.6	1307.6	11.5	2683.7	11.0
Agricultural 3/	141.4	1.1	386.9	3.4	528.3	2.2
Other 4/	1731.0	13.4	253.4	2.2	1984.4	8.1
Equipment	129.6	1.0	123.6	1.1	253.2	1.0
Other commodities	613.3	4.7	2423.0	21.2	3036.3	12.5
TOTAL	12965.6	100.0	11414.3	100.0	24379.9	100.0

1/ First six auctions, through November 17, i.e., all auctions for which the 45-day limit for opening letters of credit had expired by end-1986. Privately-financed import data are derived from LC/s opened in Mogadishu from private import accounts.
2/ Largely rice, vegetable oil, and beverages.
3/ Privately-financed imports of "chemicals" are assumed to be mainly destined to agriculture.
4/ For purposes of this comparison, privately-financed imports exclude $ 1.7 million in fuel imported by a private individual in September.

STATUTORY CHECKLIST

3(A)2 - NONPROJECT ASSISTANCE CHECKLIST

The criteria listed in Part A are applicable generally to FAA funds, and should be used irrespective of the program's funding source. In Part B a distinction is made between the criteria applicable to Economic Support Fund assistance and the criteria applicable to Development Assistance. Selection of the criteria will depend on the funding source for the program.

CROSS REFERENCES: IS COUNTRY CHECKLIST UP TO DATE? — Yes
HAS STANDARD ITEM CHECKLIST BEEN REVIEWED? — Yes

A. GENERAL CRITERIA FOR NONPROJECT ASSISTANCE

1. FY 1987 Continuing Resolution Sec. 523; FAA Sec. 634A. Describe how authorization and appropriations committees of Senate and House have been or will be notified concerning the project.

   CN Sent to Hill on July 6, 1987 and 15-day waiting period expired without objection on July 20, 1987.

2. FAA Sec. 611(a)(2). If further legislative action is required within recipient country, what is basis for reasonable expectation that such action will be completed in time to permit orderly accomplishment of purpose of the assistance?

   N/A. All legislation required has already been enacted.

3. FAA Sec. 209. Is assistance more efficiently and effectively provided through regional or multilateral organizations? If so, why is assistance not so provided? Information and conclusions on whether assistance will encourage developing countries to cooperate in regional development programs.

   No.

   N/A

4.	FAA Sec. 601(a). Information and conclusions on whether assistance will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture, and commerce; and (f) strengthen free labor unions.	Program funds for auction to the private sector will increase the flow of international trade, foster private initiative and competition, discourage monopolistic practices, and improve technical efficiency.
5.	FAA Sec. 601(b). Information and conclusions on how assistance will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).	By supporting exchange unification, A.I.D. funds will encourage U.S. trade and investment. Code 935 funds for auction provide a resource for imports of U.S. origin.
6.	FAA Secs. 612(b), 636(h); FY 1987 Continuing Resolution Secs. 507, 509. Describe steps taken to assure that, to the maximum extent possible, foreign currencies owned by the U.S. are utilized in lieu of dollars to meet the cost of contractual and other services.	U.S. does not own local currencies.
7.	FAA Sec. 612(d). Does the U.S. own excess foreign currency of the country and, if so, what arrangements have been made for its release?	No.
8.	FAA Sec. 601(e). Will the assistance utilize competitive selection procedures for the awarding of contracts, except where applicable procurement rules allow otherwise?	N/A
9.	FAA 121(d). If assistance is being furnished under the Sahel Development Program, has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of A.I.D. funds?	I/A
10.	FY 1987 Continuing Resolution Sec. 532. Is disbursement of the assistance conditioned solely on the basis of the	No.

B. FUNDING CRITERIA FOR NONPROJECT ASSISTANCE

1. Nonproject Criteria for Economic Support Fund

a. FAA Sec. 531(a). Will this assistance promote economic and political stability? To the maximum extent feasible, is this assistance consistent with the policy directions, purposes, and programs of Part I of the FAA?

Yes.

Yes.

b. FAA Sec. 531(e). Will assistance under this chapter be used for military or paramilitary activities?

No.

c. FAA Sec. 531(d). Will ESF funds made available for commodity import programs or other program assistance be used to generate local currencies? If so, will at least 50 percent of such local currencies be available to support activities consistent with the objectives of FAA sections 103 through 106?

Yes.

Yes.

d. ISDCA of 1985 Sec. 205. Will ESF funds made available for commodity import programs be used for the purchase of agricultural commodities of United States-origin? If so, what percentage of the funds will be so used?

N/A

e. ISDCA of 1985 Sec. 801. If ESF funds will be used to finance imports by an African country (under a commodity import program or sector program), will the agreement require that those imports be used to meet long-term development needs in those countries in accordance with the following criteria?

N/A

(i) spare parts and other imports shall be allocated on the basis of evaluations, by A.I.D., of the ability of likely recipients to use such spare parts and imports in a maximally productive, employment generating, and cost-effective way;

(ii) imports shall be coordinated with investments in accordance with the recipient country's plans for promoting economic development. A.I.D. shall assess such plans to determine whether they will effectively promote economic development;

(iii) emphasis shall be placed on imports for agricultural activities which will expand agricultural production, particularly activities which expand production for export or production to reduce reliance on imported agricultural products;

(iv) emphasis shall also be placed on a distribution of imports having a broad development impact in terms of economic sectors and geographic regions;

(v) in order to maximize the likelihood that the imports financed by the United States under the ESF chapter are in addition to imports which would otherwise occur, consideration shall be given to historical patterns of foreign exchange uses;

(vi)(A) 75 percent of the foreign currencies generated by the sale of such imports by the government of the country shall be deposited in a special account established by that government and, except as provided in subparagraph (B), shall be available only for use in accordance with the agreement for economic development activities which are consistent with the policy directions of section 102 of the FAA and which are the types of activities for which assistance may be provided under sections 103 through 106 of the FAA;

(B) the agreement shall require that the government of the country make available to the United States Government such portion of the amount deposited in the special account as may be determined by the President to be necessary for requirements of the United States Government.

f. ISDCA of 1985 Sec. 207. Will ESF funds be used to finance the construction of, or the operation or maintenance of, or the supplying of fuel for, a nuclear facility? If so, has the President certified that such country (1) is a party to the Treaty on the Non-Proliferation of Nuclear Weapons or the Treaty for the Prohibition of Nuclear Weapons in Latin American (the "Treaty of Tlatelolco"), (2) cooperates fully with the IAEA, and (3) pursues nonproliferation policies consistent with those of the United States?

No.

N/A

g. FAA Sec. 609. If commodities are to be granted so that sale proceeds will accrue to the recipient country, have Special Account (counterpart) arrangements been made?

N/A

h. FY 1987 Continuing Resolution. If assistance is in the form of a cash transfer to any country which receives in excess of a total of $5 million as cash transfer assistance in the current fiscal year: (a) are all such cash payments to be maintained by the country in a separate account and not to be commingled with any other funds? (b) will all local currences that may be generated with funds provided as a cash transfer to such a country also be deposited in a special account to be used in accordance with FAA Section 609 (which requires such local currencies to be made available to the U.S. government as the U.S. determines necessary for the requirements of the U.S. Government, and which requires the remainder to be used for programs agreed to by the U.S. Government to carry out the purposes for which new funds authorized by the FAA would themselves be available)?

(a) Yes.

(b) Yes.

2. <u>Nonproject Criteria for Development Assistance</u>

a. <u>FAA Secs. 102(a), 111, 113, 281(a)</u>. Extent to which activity will (a) effectively involve the poor in development, by expanding access to economy at local level, increasing labor-intensive production and the use of appropriate technology, spreading investment out from cities to small towns and rural areas, and insuring wide participation of the poor in the benefits of development on a sustained basis, using the appropriate U.S. institutions; (b) help develop cooperatives, especially by technical assistance, to assist rural and urban poor to help themselves toward better life, and otherwise encourage democratic private and local governmental institutions; (c) support the self-help efforts of developing countries; (d) promote the participation of women in the national economies of developing countries and the improvement of women's status; and (e) utilize and encourage regional cooperation by developing countries? N/A

b. <u>FAA Secs. 103, 103A, 104, 105, 106, 120-21</u>. Is assistance being made available (include only applicable paragraph which corresponds to source of funds used; if more than one fund source is used for assistance, include relevant paragraph for each fund source):

(1) [103] for agriculture, rural development or nutrition; if so (a) extent to which activity is specifically designed to increase productivity and income of rural poor; [103A] if for agricultural research, account shall be taken of the needs of small farmers, and extensive use of field testing to adapt basic research to local conditions shall be made; (b) extent to which assistance is used in coordination with efforts carried out under Sec. 104 to help improve nutrition of the people of developing countries through encouragement of increased production of crops with greater nutritional value; (1) N/A

improvement of planning, research, and education with respect to nutrition, particularly with reference to improvement and expanded use of indigenously produced foodstuffs; and the undertaking of pilot or demonstration programs explicitly addressing the problem of malnutrition of poor and vulnerable people; and (c) extent to which activity increases national food security by improving food policies and management and by strengthening national food reserves, with particular concern for the needs of the poor, through measures encouraging domestic production, building national food reserves, expanding available storage facilities, reducing post harvest food losses, and improving food distribution.

(2) [104] for population planning under Sec. 104(b) or health under Sec. 104(c); if so, extent to which activity emphasizes low-cost, integrated delivery systems for health, nutrition and family planning for the poorest people, with particular attention to the needs of mothers and young children, using paramedical and auxiliary medical personnel, clinics and health posts, commercial distribution systems, and other modes of community outreach.

(2) N/A

(3) [105] for education, public administration, or human resources development; if so, (a) extent to which activity strengthens nonformal education, makes formal education more relevant, especially for rural families and urban poor, and strengthens management capability of institutions enabling the poor to participate in development; and (b) extent to which assistance provides advanced education and training of people of developing countries in such disciplines as are required for planning and implementation of public and private development activities.

(3) N/A

(4) [106] for technical assistance, energy, research, reconstruction, and selected development problems; if so, extent activity is: N/A

(i)(a) concerned with data collection and analysis, the training of skilled personnel, research on and development of suitable energy sources, and pilot projects to test new methods of energy production; and (b) facilitative of research on and development and use of small-scale, decentralized, renewable energy sources for rural areas, emphasizing development of energy resources which are environmentally acceptable and require minimum capital investment; N/A

(ii) concerned with technical cooperation and development, especially with U.S. private and voluntary, or regional and international development, organizations; N/A

(iii) research into, and evaluation of, economic development processes and techniques; N/A

(iv) reconstruction after natural or manmade disaster and programs of disaster preparedness; N/A

(v) for special development problems, and to enable proper utilization of infrastructure and related projects funded with earlier U.S. assistance; N/A

(vi) for urban development, especially small, labor-intensive enterprises, marketing systems for small producers, and financial or other institutions to help urban poor participate in economic and social development. N/A

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(5) [120-21] for the Sahelian region; if so, (a) extent to which there is international coordination in planning and implementation; participation and support by African countries and organizations in determining development priorities; and a long-term, multi-donor development plan which calls for equitable burden-sharing with other donors; (b) has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of projects funds (dollars or local currency generated therefrom)?

N/A

c. FAA Sec. 107. Is special emphasis placed on use of appropriate technology (defined as relatively smaller, cost-saving, labor using technologies that are generally most appropriate for the small farms, small businesses, and small incomes of the poor)?

N/A

d. FAA Sec. 281(b). Describe extent to which the activity recognizes the particular needs, desires, and capacities of the people of the country; utilizes the country's intellectual resources to encourage institutional development; and supports civic education and training in skills required for effective participation in governmental and political processes essential to self-government.

This program recognizes the Somali private sector's needs and capacity for economic development given access to a market-allocated supply of foreign exchange for imports.

e. FAA Sec. 101(a). Does the activity give reasonable promise of contributing to the development of economic resources, or to the increase of productive capacities and self-sustaining economic growth?

Yes.

5C(1) - COUNTRY CHECKLIST Somalia - FY 1987

Listed below are statutory criteria applicable to: (A) FAA funds generally; (B)(1) Development Assistance funds only; or (B)(2) the Economic Support Fund only.

A. <u>GENERAL CRITERIA FOR COUNTRY ELIGIBILITY</u>

1. <u>FY 1987 Continuing Resolution Sec. 526</u>. Has the President certified to the Congress that the government of the recipient country is failing to take adequate measures to prevent narcotic drugs or other controlled substances which are cultivated, produced or processed illicitly, in whole or in part, in such country or transported through such country, from being sold illegally within the jurisdiction of such country to United States Government personnel or their dependents or from entering the United States unlawfully? No

2. <u>FAA Sec. 481(h)</u>. (This provision applies to assistance of any kind provided by grant, sale, loan, lease, credit, guaranty, or insurance, except assistance from the Child Survival Fund or relating to international narcotics control, disaster and refugee relief, or the provision of food or medicine.) If the recipient is a "major illicit drug producing country" (defined as a country producing during a fiscal year at least five metric tons of opium or 500 metric tons of coca or marijuana) or a "major drug-transit country" (defined as a country that is a significant direct source of illicit drugs significantly affecting the United States, through which such drugs are transported, or through which significant sums of drug-related profits are laundered with the knowledge or complicity of the government), has the President in the March 1 International Narcotics Control Strategy Report (INSCR) determined and certified to the Congress (without NA

Congressional enactment, within 30 days of continuous session, of a resolution disapproving such a certification), or has the President determined and certified to the Congress on any other date (with enactment by Congress of a resolution approving such certification), that (a) during the previous year the country has cooperated fully with the United States or taken adequate steps on its own to prevent illicit drugs produced or processed in or transported through such country from being transported into the United States, and to prevent and punish drug profit laundering in the country, or that (b) the vital national interests of the United States require the provision of such assistance?

3. Drug Act Sec. 2013. (This section applies to the same categories of assistance subject to the restrictions in FAA Sec. 481(h), above.) If recipient country is a "major illicit drug producing country" or "major drug-transit country" (as defined for the purpose of FAA Sec 481(h)), has the President submitted a report to Congress listing such country as one (a) which, as a matter of government policy, encourages or facilitates the production or distribution of illicit drugs; (b) in which any senior official of the government engages in, encourages, or facilitates the production or distribution of illegal drugs; (c) in which any member of a U.S. Government agency has suffered or been threatened with violence inflicted by or with the complicity of any government officer; or (d) which fails to provide reasonable cooperation to lawful activities of U.S. drug enforcement agents, unless the President has provided the required certification to Congress pertaining to U.S. national interests and the drug control and criminal prosecution efforts of that country? NA

4. FAA Sec. 620(c). If assistance is to a government, is the government liable as debtor or unconditional guarantor on any debt to a U.S. citizen for goods or services furnished or ordered where (a) such citizen has exhausted available legal remedies and (b) the debt is not denied or contested by such government? — No

5. FAA Sec. 620(e)(1). If assistance is to a government, has it (including any government agencies or subdivisions) taken any action which has the effect of nationalizing, expropriating, or otherwise seizing ownership or control of property of U.S. citizens or entities beneficially owned by them without taking steps to discharge its obligations toward such citizens or entities? — No

6. FAA Secs. 620(a), 620(f), 620D; FY 1987 Continuing Resolution Secs. 512, 560. Is recipient country a Communist country? If so, has the President determined that assistance to the country is important to the national interests of the United States? Will assistance be provided to Angola, Cambodia, Cuba, Iraq, Syria, Vietnam, Libya, or South Yemen? Will assistance be provided to Afghanistan without a certification? — No

7. FAA Sec. 620(j). Has the country permitted, or failed to take adequate measures to prevent, damage or destruction by mob action of U.S. property? — No

8. FAA Sec. 620(l). Has the country failed to enter into an investment guaranty agreement with OPIC? — No

9. FAA Sec. 620(o); Fishermen's Protective Act of 1967 (as amended) Sec. 5. (a) Has the country seized, or imposed any penalty or sanction against, any U.S. fishing vessel because of fishing activities in international waters? (b) If so, has any deduction required by the Fishermen's Protective Act been made? — No

10. FAA Sec. 620(q); FY 1987 Continuing Resolution Sec. 518. (a) Has the government of the recipient country been in default for more than six months on interest or principal of any loan to the country under the FAA? (b) Has the country been in default for more than one year on interest or principal on any U.S. loan under a program for which the FY 1987 Continuing Resolution appropriates funds?

(a) No

(b) Somalia will not be be subject to Brooke until September 2, 1987.

11. FAA Sec. 620(s). If contemplated assistance is development loan or from Economic Support Fund, has the Administrator taken into account the percent of the country's budget and amount of the country's foreign exchange or other resources spent on military equipment? (Reference may be made to the annual "Taking Into Consideration" memo: "Yes, taken into account by the Administrator at time of approval of Agency OYB." This approval by the Administrator of the Operational Year Budget can be the basis for an affirmative answer during the fiscal year unless significant changes in circumstances occur.)

Yes, taken into account by the Administrator at time of approval of Agency OYB.

12. FAA Sec. 620(t). Has the country severed diplomatic relations with the United States? If so, have relations been resumed and have new bilateral assistance agreements been negotiated and entered into since such resumption?

NO

13. FAA Sec. 620(u). What is the payment status of the country's U.N. obligations? If the country is in arrears, were such arrearages taken into account by the A.I.D. Administrator in determining the current A.I.D. Operating Year Budget? (Reference may be made to the Taking into Consideration memo.)

While Somalia was in arrears as of September 30, 1986, this was taken into consideration. Somalia was not delinquent within the meaning of Article 19 of the UN Charter.

14. FAA Sec. 620A. Has the President determined that the recipient country grants sanctuary from prosecution to any individual or group which has committed an act of international terrorism or otherwise supports international terrorism?

NO

15. ISDCA of 1985 Sec. 552(b). Has the Secretary of State determined that the country is a high terrorist threat country after the Secretary of Transportation has determined, pursuant to section 1115(e)(2) of the Federal Aviation Act of 1958, that an airport in the country does not maintain and administer effective security measures?

NO

16. FAA Sec. 666(b). Does the country object, on the basis of race, religion, national origin or sex, to the presence of any officer or employee of the U.S. who is present in such country to carry out economic development programs under the FAA?

NO

17. FAA Secs. 669, 670. Has the country, after August 3, 1977, delivered to any other country or received nuclear enrichment or reprocessing equipment, materials, or technology, without specified arrangements or safeguards, and without special certification by the President? Has it transferred a nuclear explosive device to a non-nuclear weapon state, or if such a state, either received or detonated a nuclear explosive device? (FAA Sec. 620E permits a special waiver of Sec. 669 for Pakistan.)

NO

18. FAA Sec. 670. If the country is a non-nuclear weapon state, has it, on or after August 8, 1985, exported (or attempted to export) illegally from the United States any material, equipment, or technology which would contribute significantly to the ability of a country to manufacture a nuclear explosive device?

NO

19. ISDCA of 1981 Sec. 720. Was the country represented at the Meeting of Ministers of Foreign Affairs and Heads of Delegations of the Non-Aligned Countries to the 36th General Assembly of the U.N. on Sept. 25 and 28, 1981, and failed to disassociate itself from the communique issued? If so, has the President taken it into account? (Reference may be made to the Taking into Consideration memo.)

Somalia was represented and failed to disassociate itself. This was taken into account at time of approval of OYB.

20. FY 1987 Continuing Resolution Sec. 528. Has the recipient country been determined by the President to have engaged in a consistent pattern of opposition to the foreign policy of the United States? NO

21. FY 1987 Continuing Resolution Sec. 513. Has the duly elected Head of Government of the country been deposed by military coup or decree? NO

B. FUNDING SOURCE CRITERIA FOR COUNTRY ELIGIBILITY

1. Development Assistance Country Criteria

FAA Sec. 116. Has the Department of State determined that this government has engaged in a consistent pattern of gross violations of internationally recognized human rights? If so, can it be demonstrated that contemplated assistance will directly benefit the needy? NO

2. Economic Support Fund Country Criteria

FAA Sec. 502B. Has it been determined that the country has engaged in a consistent pattern of gross violations of internationally recognized human rights? If so, has the President found that the country made such significant improvement in its human rights record that furnishing such assistance is in the U.S. national interest? NO

Initial Environmental Examination

Project Country: Somalia

Project Title and Number: Somalia Foreign Exchange Market Support II 649-0139

Funding: 15.5 million

Life of Project: FY 1987

IIE Prepared by: Stafford Baker, AFR/PD/EAP

Environmental Action Recommended: Categorical Exclusion

The program will provide a $15.5 million cash transfer to support Somalia's structural adjustment program for foreign exchange rate unification through an auction mechanism. As a contribution to the Somali government for purposes not related to carrying out specifically identifiable projects, this activity qualifies for a categorical exclusion under Section 216.2 (c)(2)(vi) of A.I.D.'s Environmental Procedures.

Action Recommended by: Tom Lofgren, AFR/PD/EAP

Bureau Environmental Advisor : Bessie L. Boyd B. Boyd
AFR/TR/PRO

Approved: X
Disapproved:
Date: JUL 23 1987

GC/AFR Concurrence: Mary Alice Kleinman
7/23/87

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ANNEX F

ILLUSTRATIVE LIST OF LOCAL CURRENCY PROGRAMS

It is not possible to specify precise uses of local currency generations since programming of local currency is done jointly with the GSDR at the end of each calendar year. However, the following is an illustrative list of projects and amounts based on CY 87 budgets for ESF generations (CIP and cash sales combined).

CY 87 Bilateral Projects Funded With Local Currency (in millions of shillings)

- Refugee Self-Reliance (52.7)
- CDA Forestry (7.8)
- Kismayo Port (1)
- Family Health Services (220)
- SOMTAD (33 approved, possibly to be raised to 55-60 in July Reprogramming)
- PIP (45 approved, possibly to be raised to 60 in July Reprogramming)
- PVO Partners (84 approved, possibly to be raised to 100 in July Reprogramming)
- RHUDO (.5)
- USAID Trust Fund (197 - for Livestock Marketing and Health Quarantine Station Construction)
- Joint Reserve Fund (235 - includes 85 for USAID Trust Fund)

CY 1987 GSDR Projects Funded With Local Currency (in millions of shillings)

- TSTSE Fly (22)
- Northern Rangeland (10)
- Mogadishu Water Supply (28.8)
- Hargeisa-Borama Road (57.6)
- Jasira Power Station (13)
- Burdhubo Bridge (95)
- Baidoa/Kismayo Electrication (8.96)
- Mogadishu New Telephone and Telex (6)
- Primary Education (25)
- Technical Secondary Education (34)
- Technical Teacher TRaining College (7)
- SOMAC/SAREC (Higher Education) (3.8)
- Statistical Base (.7)
- Strengthening human Resource (.75)
- Assistance to Planning Department (1.3)
- National Monitoring/Evaluation (1)
- Ministry of Finance/DDD (2.38)