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Guinea: Staff-Monitored Program: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

November 29, 2005

The following item is a Letter of Intent and a Memorandum of Economic and Financial Policies of the government of Guinea. The document, which is the property of Guinea, is being made available on the IMF website by agreement with the member as a service to users of the IMF website. This memorandum describes the policies that is implementing in the framework of a staffmonitored program. A member's staff-monitored program is an informal and flexible instrument for dialogue between the IMF staff and a member on its economic policies. A staffmonitored program is not supported by the use of the Fund's financial resources; nor is it subject to the endorsement of the Executive Board of the IMF.

Conakry, November 29, 2005

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

Dear Mr. de Rato,

1. Guinea is implementing a staff-monitored economic and financial program (SMP) covering the period April 2005-March 2006.

2. We have made important progress under our program. In particular, all the quantitative targets and structural benchmarks for end-June, with the exception of the target relating to the accumulation of net foreign assets by the Central Bank of the Republic of Guinea (BCRG), were met.

3. The attached memorandum (Annex I) outlines the additional economic and financial policies that the government intends to implement in addition to the policies described in our letter to you of May 31, 2005. The government is implementing the additional policies to ensure that the macroeconomic and structural objectives under the SMP will be met in a timely manner and on the basis of good policies.

4. The government undertakes to provide Fund staff with all the information needed to monitor the implementation of the measures envisaged under the program and the achievement of its objectives. The attached technical memorandum of understanding restates the programs targets and benchmarks for the period until March 2006, defines the relevant economic variables, and specifies the type of data to be reported to the IMF (Annex II).

5. The Guinean government believes that the additional policies and measures set forth in the attached memorandum will help ensure the achievement of the objectives of the program. If necessary, it stands ready to take any further measures that may become appropriate for this purpose.

6. During the program period, the government will consult with you, at its own initiative or when you request it, regarding Guinea's economic and financial policies.

7. In order to evaluate progress achieved in program implementation, the IMF staff, in conjunction with the government of Guinea, will conduct the next staff assessment by early-December 2005 based on the benchmarks for end-September 2005.

8. The Guinean government agrees to the publication of this letter and of the government's memorandum of economic and financial policies

9. Please accept this letter with our highest regards.

Sincerely yours,

/s/ /s/

Alkaly Mohammed Daffé
Governor of the BCGR

Madikaba Camara
Minister of Economy and Finance

Attachment: - Memorandum on Economic and Financial Policies for the Period September 2005 – March 2006

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

FOR THE PERIOD SEPTEMBER 2005 – MARCH 2006

I. INTRODUCTION

1. Within the framework of a staff-monitored program (SMP), Guinea adopted a program—covering the period April 2005-March 2006—of prudent fiscal and monetary policies and structural reform. The program is intended to stabilize the economy and thus lay the basis to accelerate growth, reduce poverty, and lay a solid basis for achievement of the Millennium Developments Goals.

2. This Memorandum is a complement to the Memorandum of May 31, 2005. It reports on recent developments, and describes the additional policies necessary to ensure achievement of the quantitative targets and structural benchmarks during the remaining period of the SMP.

II. RECENT ECONOMIC DEVELOPMENTS

3. **As envisaged in the program, real GDP growth is recovering moderately and is expected to reach 3 percent in 2005.** The improvement in real GDP growth reflects a rebound of agricultural activity as well as stronger growth in the construction and mining sectors. Several large investment projects are expected to come on stream and to contribute to strong growth and exports in the mining sector in the coming years.

4. **However, inflation has remained above the programmed level.** Inflation is expected to reach 28 percent by the end of 2005 (12-month basis), reflecting the faster-than-expected depreciation of the Guinean franc as well as the effects of the significant increase in domestic petroleum prices decreed last May. The exchange rate moved from 2,850 Guinea francs per U.S. dollar on March 1 to 3,827 on June 30, compared to 3,200 in the program. However, the depreciation of the exchange rate has slowed significantly since mid-June, while at the same time the spread between the exchange rate in the banks and the exchange houses has dropped to less than 5 percent.

5. **The balance of payments is expected to improve in 2005.** The current account deficit is expected to contract from 5½ percent of GDP in 2004 to 3.8 percent of GDP in 2005, while the overall balance is expected to improve from a deficit of 2.5 percent of GDP in 2004 to a surplus of 0.1 percent of GDP in 2005. The increase in the price of bauxite and alumina boosted the value of exports, whereas the faster-than-expected exchange rate depreciation dampened non-oil imports. Gross international reserves are expected to increase

from 0.8 to 1.3 months of imports during 2005. Earlier this year, the international reserves of the central bank were adjusted downwards by the equivalent of ⅓ months of imports to reflect a 2003 cash payment to a government supplier which had remained unaccounted for; the central bank has initiated action to recover the funds, and intends to use them to reconstitute international reserves.

6. **All end-June quantitative targets under the SMP were met, except for the accumulation of central bank net foreign assets (NFA).** Fiscal revenue targets were achieved and expenditure commitments were kept under control as programmed. The overall fiscal balance (cash basis) reached a surplus of 0.2 percent of GDP in the first half of the year, compared to a deficit of 1 percent of GDP under the program, and the government was able to reduce the level of domestic financing. Reserve money expansion, which had reached 49 percent on a 12-month basis by March 2005, dropped to 36 percent by end-June. Broad money expanded by 34.6 percent in the year ended in June 2005, compared to 32.1 percent under the program, but this was the result of the effect of the faster-than-expected depreciation of the Guinean franc on the value of foreign currency deposits. The NFA of the central bank expanded by US$13 million in the first half of 2005, but this was not enough to meet the SMP target.

7. **There has been important progress in the area of structural reform in the last few months, and all end-June structural benchmarks under the SMP were met except the continuous benchmark on refraining from introducing new multiple currency practices.** The initial steps to liberalize the foreign exchange market were implemented last March; however, a multiple currency practice remains arising from the potential spread of more than 2 percent between interbank market spot rates and the central bank's reference rate. Regarding fiscal reform, the WAEMU common external tariff was adopted and reforms in the customs and tax administrations and in public expenditure management advanced as expected. There was progress under the divestiture program, including the sale of shares in the largest commercial bank to a foreign bank for about US$2 million in September 2005. Action plans to reduce fraud and enhance the efficiency of the water and electricity sectors were adopted. Finally, work on the audits of the central bank accounts and foreign asset position is almost complete.

8. **Despite the large increase in domestic petroleum prices of last May, the domestic petroleum sector continues to face serious difficulties.** The petroleum companies are again selling at a loss in the domestic market, owing to the rapid increase of international oil prices coupled with the depreciation of the exchange rate. This situation needs to be addressed to ensure continued supply of petroleum products in the domestic market.

9. **Guinea continued to experience difficulties in meeting its payments to the Fund on a timely basis.** As of the SMP test date of June 30, Guinea had overdue obligations

amounting to SDR 3 million, which were not settled until mid-August. To avoid the recurrence of this problem, the government will adopt a strategy of paying upcoming obligations in advance of the due date. We have already deposited in our SDR account the necessary funds to cover all obligations to the IMF falling due in 2005, and we will continue to use this mechanism for the settlement of future payments to the IMF.

III. Economic and Financial Policies for September 2005-March 2006

10. **The government confirms its strong commitment to the objectives of the SMP.** Current financial policies will be strengthened and additional steps will be taken as needed to ensure success in reducing inflation, promoting growth, and accumulating international reserves. To achieve its objectives, the government will maintain a tight stance of fiscal and monetary policies, and will take measures to strengthen the institutional framework and enhance the efficiency of the foreign exchange market. Also, the government will adopt measures to ensure the continued supply of petroleum products in Guinea.

Fiscal policy

11. **Fiscal performance was satisfactory during the period January-August 2005.** Revenue growth exceeded program objectives, especially in the area of international trade taxes, reflecting the combined effect of improved efficiency of the tax and customs administration, the implementation of the WAEMU common external tariff, and the faster rate of currency depreciation. The faster-than-expected exchange rate depreciation also has exerted substantial pressure on government expenditures, but the government was able to contain total outlays within the confines of the budget. The end-August primary surplus was 0.5 percentage points of GDP higher than targeted and the overall deficit, excluding grants, was 0.2 percentage points lower than expected, which allowed the government to reduce its net indebtedness vis-à-vis the central bank.

12. **The government will take specific measures during the last quarter of the year to ensure meeting the SMP's fiscal targets in the face of additional expenditure pressures.** Initial projections indicate that primary current expenditure during the last quarter of the year could exceed program projections, in part owing to additional pressure from the higher rate of currency depreciation. The government has decided to reduce expenditures on goods and services for at least 10 billion relative to the latest projections, mainly by pursuing efforts to limit foreign mission expenditures and containing transfers and subsidies to their program level.

13. **Faced with particular problems in the last few months, the government took measures not envisaged in the SMP policy framework.** First, to ensure availability of

foreign exchange to meet external debt service obligations, including to the Fund, the government received last August an interest-free advance of tax payments for US$18 million from the mining companies. To avoid the rigidity that such operations introduce in the budget, the government undertakes not to use future tax payments to meet current obligations during the period of the SMP. Second, faced with the increase in the cost of imported rice, the authorities agreed to provide an exchange rate guarantee to rice importers through September 2005. In the future, when faced with similar situations, the government will consult with the IMF on any policy actions that were not envisaged in its reform plan agreed with the IMF staff.

14. **The 2006 government budget is a key instrument to consolidate progress under the SMP.** It is being prepared on the basis of further strengthening of revenue collection, controlling the expansion of expenditures, and reducing central bank financing of the government as well as refraining from the use of nonconcessional external resources. As part of the 2006 budget preparation efforts, the government will take steps to gain better control over government activities that still remain outside the realm of the budget, and will request technical assistance from the IMF in this regard. The finance law for 2006 also will address the issue of the pricing mechanism of petroleum products in the domestic market (see below). Furthermore, the government will seek to improve expenditure composition to insure that the 2006 budget reflects the recommendations of the second progress report of the poverty reduction strategy.

Monetary and exchange policy

15. **Monetary and exchange policy will be conducted in a manner consistent with the targets and objectives of the SMP.** In this regard, the central bank will follow closely the recommendations made by the August 2005 mission of the IMF Monetary and Financial Systems Department (MFD), as described in the next two paragraphs.

16. **The central bank will implement policies to encourage the participation of economic agents in the formal foreign exchange market and to allow the market to be representative of the true underlying conditions in the economy.** First, the central bank will start calculating the reference exchange rate as a weighted average of the amounts transacted by the banks and exchange houses. At the same time, the central bank will take steps (including on-site inspections) to guarantee timely and complete reporting by the banks and the exchange bureaus of actual exchange rates and of volumes transacted. The central bank intends to start publishing a daily reference rate based on intra-day data, which will eliminate the remaining multiple currency practice. Also, the central bank will continue reducing the backlog in transferring banks' foreign exchange to correspondents abroad. In the last quarter of 2005, the central bank will set up an internal control structure for its foreign exchange operations as well as an agreement detailing the obligations of the central bank and the commercial banks in the foreign exchange market. During the last quarter of

2005, the central bank also will reorganize of its Foreign Exchange Department, while foreign exchange market regulations will be reviewed to reflect the institutional changes in the foreign exchange market implemented so far. The central bank also will assess the operation of the regulation on maximum withdrawals of foreign exchange cash. Finally, the central bank will work closely with the customs administration, the banking system and exporters to ensure full repatriation of export revenues in accordance with existing regulations.

17. **The central bank will implement policies that will allow it to transmit to the markets the stance of monetary policy and to support its operations in the foreign exchange market.** Given the situation of structural excess liquidity in the market—apparent in the large level of excess reserves that the banks maintain in the central bank—the reserve requirement coefficient on bank deposits will be increased in October 2005 to 9 ½ percent of bank deposits, after consultation with the commercial banks. At the same time, the period for calculation of compliance with reserve requirements will be extended from 10 to 15 days. To enhance the role of the auctions of central bank bills (TRMs) as a monetary policy instrument, the auctions of Treasury bills and TRMs will be carried out in different days of the week. The Treasury Committee will be reactivated to enhance the communication between the Treasury and the central bank, while a Liquidity Committee will be set up in the central bank. At the same time, the central bank will start work to revise the regulations pertaining to central bank advances to the government, with a view to eliminate statutory advances in the future.

The petroleum sector

18. **The government will introduce an automatic price adjustment mechanism for petroleum products in the 2006 budget law.** This automatic price adjustment mechanism will fully reflect exchange rate and international oil price conditions, and will be applied on a regular monthly basis. If the government decides to lower domestic petroleum taxes as part of the new price mechanism to ensure that the price structure in Guinea does not deviate from that in neighboring countries to a significant degree, other measures for an equal amount of resources will be identified so as to reach a neutral fiscal effect. In the meantime, the government will start implementing limited monthly adjustments of domestic oil prices in the fourth quarter of 2005.

IV. PROGRAM MONITORING

19. Program implementation will continue to be monitored on the basis of the quantitative indicators and structural benchmarks specified in the Memorandum of May 31, 2005, for end-September and end-December 2005 and end-March 2006. Table 1 specifies the quantitative targets of the program, which are identical to those of the Memorandum of May 31, 2005, except for two adjustments. First, the stock of net foreign assets of the central bank has been revised downwards throughout by about US$23 million, following the adjustment to the central bank balance sheet on account of a 2003 import operation mentioned above (repayments received by the central bank corresponding to this operations will not count towards meeting the program objectives). Second, the target for the accumulation of net foreign assets of the central bank has been (a) revised upwards from June 2005 for US$1 million of exceptional budget assistance received from China, and (b) revised downwards from December 2005 for 75 percent of US$8.2 million of projected foreign financing from the European Union that is no longer expected to be received during the SMP period. The next quarterly staff assessment of the program will take place on the basis of data for end-September 2005.

Table 1. Structural Benchmarks for the 2005-06 Staff-Monitored Program

Areas	Measures	Implementation Date	Status of Implementation
Tax administration			
	• Adoption of an action plan with a timetable for strengthening tax and customs administrations, based on the recommendations of the IMF technical assistance missions.	End-June 2005.	Completed.
	• Moratorium on new ad hoc tax or customs tariff exemptions.	On a continuous basis.	
Expenditure control			
	• Establishment of a monitoring committee to review the operation of the computerized expenditure management system and prepare the terms of reference for a complete computer network audit.	End-June 2005.	Completed.
	• Amend Article 31 of the General Rules on Public Accounting in order to eliminate the possibility of extra budgetary transactions.	End-September 2005.	
	• Launch a call for bids for an audit of the computerized expenditure management system.	End-September 2005.	
	• Closing of all accounts held by individuals on the books of the central bank.	End-December 2005.	
	• Completion of an audit of the government's domestic debt and of the cross debts between public enterprises and the government.	End-December 2005.	

Table 1. Structural Benchmarks for the 2005-06 Staff-Monitored Program (Concluded)

Areas	Measures	Implementation Date	Status of Implementation
Fiscal issues regarding public enterprises			
	• Adoption by the Council of Ministers of an action plan to combat fraudulent use of electricity and drinking water.	End-June 2005.	Completed.
	• Adoption of an action plan to strengthen financially the electricity and water companies.	End-September 2005.	
	• Adoption of a plan to settle cross debts between public enterprises and the government.	End-December 2005.	
Safeguards measures			
	• Completion of the special audit of the central bank's international reserves.	End-September 2005.	
	• Completion of the financial audit of the central bank itself.	End-December 2005.	
Governance			
	• Adoption of an action plan to combat corruption, including concrete objectives and performance indicators, as well as specific actions to improve governance in key public sectors and an implementation schedule.	End-September 2005.	
Exchange rate regime			
	• Refrain from introducing any new multiple currency practices.	On a continuous basis.	Not met.

Table 2. Guinea: Quantitative Indicative Targets, 2004-06

	2004	2005							2006	
		March	June		Sept.		Dec.		March	
			Targets	Est.	Targets	Est.	Targets 10/	Proj.	Targets 10/	Proj.
	(In billions of Guinean francs)									
Central government primary balance (floor) 1/	-40.3	125.0	186.0	250.2	259.7	345.5	331.5	351.6	116.9	131.6
Net bank credit to the government (ceiling) 2/ 3/ 8/	240.5	50.3	120.5	-30.1	166.3	-33.9	197.2	98.0	50.3	46.0
Reserve money (ceiling) 9/	763.3	913.3	926.2	853.0	942.5	887.9	959.6	951.3	976.9	964.2
	(In millions of U.S. dollars)									
Stock of net foreign assets of the central bank (floor) 4/ 5/ 8/	-29.6	-22.7	-12.6	-16.2	-3.9	8.6	1.8	12.0	7.3	17.6
New nonconcessional medium- or long-term external debt contracted of guaranteed by the government or the central bank (ceil	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Outstanding stock of short-term external debt contracted or guaranteed by the government or the central bank (ceiling) 5/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Stock of outstanding external payments arrears (ceiling) 6/	62.4	74.2	72.7	65.0	68.9	65.0	50.7	50.7	47.1	47.1
	(In billions of Guinean francs)									
Central government nonmining revenue 2/	765.0	246.4	498.0	554.5	992.2	1,103.5	1,002.9	1,086.8	294.8	308.7
Central government noninterest current expenditure 2/	791.0	156.5	388.3	381.9	598.2	620.2	825.9	895.5	201.9	210.7
Expenditure in priority sectors 2/ 7/	263.9	71.8	181.2	182.9	280.8	301.6	399.0	406.0	96.0	105.0
Change in domestic arrears (a "-" sign indicates repayment) 2/	21.4	4.7	4.7	4.7	0.0	-10.0	0.0	0.0	0.0	0.0
Memorandum items:										
External budgetary assistance (in millions of US dollars) 2/	0.0	0.0	0.0	1.0	0.0	1.0	0.0	1.0	0.0	0.0

1/ On a commitment basis; the domestic primary balance is defined as the difference between total revenue (excluding grants) and noninterest domestic expenditure, excluding foreign-financed capital expenditure.

2/ Cumulative from the beginning of the calendar year

3/ Subject to adjustment mechanisms for deviation in cash settlement of domestic arrears and disbursement of external budgetary assistance as specified in the Technical Memorandum of Understanding (TMU).

4/ Subject to adjustment mechanisms for accumulation of new external arrears and deviation in disbursement of external budgetary assistance as specified in the TMU..

5/ Excluding commercial credits.

6/ Excluding arrears under negotiation with creditors; monitored on a continuous basis.

7/ Priority sectors include public health, education, transport, road maintenance, justice, rural development, urban planning, and social affairs. This expenditure includes outlays funded by HIPC resources.

8/ The program targets have been revised downwards throughout by about US$23 million, following the adjustment to the central bank balance sheet on account of of a foreign exchange transaction between the Central Bank and a private company. The targets from end-June are also adjusted upward for US$ 1 million of budgetary assistance obtained from China in June 2005 and which was not expected in the program.

9/ The reserve money is reported at program exchange rates 3200 GNF/USD for end-June; 3276 GNF/USD for end-September; 3335 GNF/USD for end-December; 3496 GNF/USD for end-March 2006.

10/ The target for NFA from end-December 2005 is adjusted downward for 75 percent of US$8.2 million of EU budgetary assistance that was programmed, but is not expected to be received as scheduled. Net bank credit to the government is also adjusted upward for the same amount in Guinean francs, recalculated at program exchange rates.