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Union of the Comoros: Staff-Monitored Program: Letter of Intent and Memorandum of Economic and Financial Policies

March 31, 2006

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Moroni, March 31, 2006

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

Dear Mr. de Rato,

During 2005, Comoros made decisive progress with national reconciliation, economic stabilization, and addressing social conditions. Our Interim-Poverty Reduction Strategy Paper (I-PRSP) was finalized in a broad and unprecedented participatory effort to develop a national strategy aimed at improving economic and social prospects for all Comorians. It also provided the foundation for the first donors' conference in over a decade that resulted in major financial pledges in support of the government's medium-term program. The first presidential elections under the new constitutional power-sharing agreements – a milestone in the national reconciliation process – will be held in April and May 2005.

The authorities' economic program for 2005, monitored under a Staff Monitored Program (SMP), provided a sound framework for economic stability in a year marked by large terms of trade shocks and volcanic eruptions. It has enabled us to make significant progress in strengthening fiscal policies and budget management. The implementation of revenue-sharing and expenditure-allocation arrangements between the Union and island governments has helped reestablish cooperation and trust in the conduct of public finances. The intensification of the policy dialogue in the context of the SMP has also helped the government strengthen its policies in other sectors.

Although not all objectives under the 2005 SMP were achieved, the overall fiscal situation has improved markedly from a year ago. In light of the shortfall in fiscal revenues in the first nine months, we took a number of corrective measures, including politically difficult tax and fuel price increases. As a result, fiscal performance in the fourth quarter came back into line with SMP objectives. For 2005 as a whole, domestic revenue as well as the primary and overall fiscal balances improved noticeably over 2004. Moreover, for the first time in years, we were able to achieve a net reduction in domestic expenditure arrears. Progress on structural reform was slower than we had hoped, partly reflecting the significant capacity constraints in Comoros, having only recently emerged from a long period of instability and internal conflict, but also due to delays in the delivery of envisaged technical assistance.

We would like to request an extension of the SMP through June 2006, to establish a credible basis for entering into a Poverty Reduction and Growth Facility (PRGF) arrangement. We expect that this will lay the ground for negotiations in June 2006, which could allow consideration of our PRGF request by the IMF's Board of Executive Directors in the third quarter of 2006. This would pave the way for eventual debt relief

under the enhanced HIPC initiative and MDRI, which will be critical for the Union of Comoros to achieve its economic development and poverty reduction objectives, as set out in our I-PRSP.

The attached Memorandum of Economic and Financial Policies reviews economic developments in 2005 and describes the policies that we intend to implement to achieve our macroeconomic and structural objectives for 2006. Table 1 shows quantitative indicative targets for end-March and end-June 2006. Table 2 identifies priority structural measures for 2006, including steps to be taken during the extension period of the SMP.

We believe that the policies set forth in the attached MEFP are adequate to achieve the objectives of our program, but will take any further measures that may become appropriate for this purpose. Throughout the duration of the program, the government will consult the Managing Director, on its own initiative or at your request, to discuss the economic and financial policies of the Union of the Comoros. We will provide the staff with information it requests for monitoring progress in program implementation.

Sincerely yours,

/s/

Oubeidi Mze Chei
Minister of State
Minister of Finance and Budget

/s/

Ahamadi Abdoulbastoi
Governor
Central Bank of the Comoros

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

1. This memorandum reviews economic performance under the staff monitored program (SMP) in 2005 and sets out the government's main policy objectives for 2006, including those to be monitored under an extension of the SMP through June 2006. Indicative quantitative and structural targets are shown in Tables 1 and 2.

I. DEVELOPMENTS IN 2005

2. Terms of trade shocks and volcanic eruptions hampered macroeconomic performance in 2005. With the plunge in world vanilla prices and surge in oil prices over the last two years, Comoros has experienced a sharp deterioration in the trade balance. The vanilla sector has virtually ceased exporting and is burdened by large debts to the financial sector. This has adversely affected economic and social conditions throughout the country.

3. Nonetheless, real GDP grew modestly in 2005. This reflected steady growth in subsistence agriculture, domestic trade, and a rebound in tourism. Inflation remained under control, despite a sharp increase in fuel prices. The large deterioration in the trade balance was broadly offset by rapid growth in remittances from the diaspora and higher tourism receipts. International reserves declined modestly, but remained high in relation to imports. Public external debt remained unsustainably high.

4. We took corrective action in the second half of 2005 to address deviations from our fiscal objectives. Most fiscal objectives monitored under the SMP were missed as of end-September, due to large revenue shortfalls and delays in implementing reforms aimed at reducing the wage bill. We compressed non-wage expenditures, raised fuel prices (by 20 percent for gasoline and by 43 percent for diesel), increased taxes on imported luxury products, and removed customs exemptions. To mitigate the social impact of these measures, import tariffs were lowered on basic foodstuffs and some other necessities.

5. Fiscal performance improved in 2005, notwithstanding the significant deviations from end-September targets. A strong rebound in domestic revenues in the fourth quarter made up for much of the earlier shortfalls. For the year as a whole, domestic revenues increased modestly relative to 2004, reaching 15½ percent of GDP, although this included the one-off effect of an exceptional dividend from the state telecom company. The envisaged ambitious reduction in the public sector wage bill was not achieved, and its share in total spending remained high, while it declined modestly in relation to GDP. As a result of the tight control of non-wage spending, the domestic primary surplus increased markedly, to 1 percent of GDP. Domestic expenditure arrears were reduced on a net basis for the first time in years. At the same time, we were not able to reach agreements on debt service relief with our major creditors, and external arrears continued to accumulate in 2005, in a reflection of the tight budgetary situation and balance of payments deterioration.

6. Regarding structural reforms, we took significant steps in the area of public finances, while progress in other areas was slower than envisaged. Our most important achievements in 2005 included the implementation of a consolidated budget with the new revenue-sharing

mechanism between the union and island budgets, the adoption of a harmonized budget nomenclature, the application of common tariffs throughout the union, the assessment of cross-debts of public entities, and the finalization of the interim Poverty Reduction strategy Paper (I-PRSP). Other reforms lagged, including on public enterprise reform, partly due to a lack of institutional capacity and delays in the delivery of envisaged technical assistance.

II. ECONOMIC AND FINANCIAL POLICIES FOR 2006

A. Macroeconomic Framework

7. Our economic program for 2006 aims to consolidate the stabilization gains achieved in 2005. It is unlikely that a broad-based economic acceleration will materialize this year, given the persistence of low international vanilla prices, high oil prices, and capacity constraints in tourism. Real GDP growth of 2½ percent is projected on the basis of steady growth in agriculture and domestic trade, and higher project financing from donors. Inflation is expected to remain under control in the context of a pegged exchange rate regime and limited wage growth. The current account deficit is expected to remain broadly unchanged from 2005, as higher payments for petroleum and investment-related imports are largely offset by a rebound in exports and official transfers. International reserves are projected to remain comfortable in relation to imports.

B. Fiscal Policy

8. Our central objective for 2006 is to consolidate the fiscal adjustment and stabilization gains we achieved in 2005. The 2006 budget provides for a domestic primary surplus of about 1 percent of GDP, broadly unchanged from the previous year, a level that should be sustainable over the medium term in the context of debt relief and the scaling-up of external financing of investment projects. The budget identifies external project and technical assistance spending of about 6¾ percent of GDP, up from 4½ percent of GDP in 2005, three-quarters of which would be grant-financed and one-quarter financed by new concessional lending from multilateral creditors. The overall budget deficit is projected to reach about 1¾ percent of GDP.

9. The 2006 budget introduces significant tax policy changes to ensure a stable revenue base in the context of sharply lower revenues from import tariffs and state-owned companies. With the support of the IMF's technical assistance, we have significantly reduced customs tariffs and expanded indirect taxation. Following earlier reductions in import tariffs on basic foodstuffs, the 2006 budget provides for a conversion of the main revenue-collecting customs tariffs into excise taxes. To compensate for the revenue loss expected from entering COMESA's free trade area in January 2006, the effective taxation (customs, excise, and sales taxes) on key non-essential products was increased and the tax base was broadened by administrative improvements to strengthen tax collection from small retail outlets and new taxes on casinos and phone cards. The general tax on income was redesigned as a tax on salaries, as recommended by the IMF's technical assistance. These compensating measures should help keep the domestic revenue-to-GDP ratio at about 15¼ percent of GDP in 2006,

notwithstanding the customs losses and the expected decline in profit taxes and dividends from state-owned companies.

10. The 2006 budget provides for an increase in social spending and a moderate decline in the total wage bill. We will continue our efforts to reduce the public sector wage bill, freeing resources for a moderate unwinding of the compression of non-wage spending in 2005. The 2006 budget allows for an increase in health and education spending, and the government will work with donors to identify possible additional funding of social expenditures. The monitoring of social expenditures has improved significantly over the last few months and should become more explicit as the new budget nomenclature is being implemented.

11. A key objective for 2006 is to avoid the accumulation of new domestic and external arrears. We will remain current on multilateral debt service and actively seek arrears clearance and debt rescheduling agreements with creditors (see Section F below). Arrears on wages and other domestic expenditure are projected to be reduced in net terms, although the degree of reduction will depend on the scale of budgetary support from donors and the degree of external debt service relief (see Section F).

C. Financial Sector and Monetary Policies

12. Our membership in the franc zone will continue to serve as the anchor for price stability and sound macroeconomic policies. With limited monetary policy options available, the central bank will seek to influence liquidity conditions through interest rate margins and prudent credit policies. The government will have access to limited bridge financing in the first half of the year, to be repaid in the second half, to support the timely payment of wages and debt service throughout the year in the context of highly seasonal revenues.

13. The central bank will seek to support the development of the financial system and strengthen its supervision. The opening of a second commercial bank will bring competition into the system and pose new challenges to supervision. The central bank will seek to expand channels of exchange of information with the supervisory authorities of the countries of origin of the banks established in Comoros. It will also expand its supervisory regime to both microfinance networks and monitor closely the quality of financial sector credit to the vanilla sector and the adequacy of provisioning for credit risk more generally.

D. Structural Reforms

14. Our structural reform agenda for 2006 centers on capacity enhancement in the public sector. This will be critical to strengthen budget management and enhance the effectiveness of foreign aid. Specific reform measures for 2006 are listed in Table 2, including those steps the government will take during the SMP extension period. The focus will be on fiscal institutions, including steps to strengthen budget accounting and management, control the wage bill, and improve tax and customs administration. An important element is to maintain the continuity of monthly coordinating meetings of the budget committee comprising

representatives of the union and the three islands. Another key area will be to address the severe shortcomings in economic statistics. Finally, we intend to set in motion reforms aimed private sector expansion, including by developing the financial sector and reforming state-owned enterprises.

15. These reforms will be difficult to implement without extensive technical assistance from our multilateral and bilateral partners. Priority areas include: (i) budget management, (ii) tax reform; (iii) expenditure reform, and (iv) economic statistics, in particular on national accounts, the balance of payments, and on social and poverty indicators.

E. PRSP Process

16. The government's medium-term structural reform agenda is to be pursued in the context of the implementation of the I-PRSP and the prospective PRGF-supported economic program. The I-PRSP identifies priority sectors and measures, including fiscal management, private sector development, governance, health, education, security, and the environment. Many of those measures hinge on the availability of financial and technical assistance. The scope and pace of implementation will thus depend on the involvement of our development partners and the realization of their pledges during the December 2005 donors' conference. Work on the full PRSP is to commence this year, with a focus on specifying short-term actions, linking priority programs to the budget framework, enhancing monitoring procedures, and identifying implementation risks.

F. External Debt and Program Financing

17. Both the stock of external public debt and near-term debt service obligations are at unsustainable levels. We intend to remain current on external debt service to multilateral creditors and build a track record of debt service to official bilateral creditors. At the same time, we will seek understandings with our official creditors on arrears clearance and rescheduling of near-term debt service. We have approached several creditors in this context. Eventually, the stock of external public debt should be addressed under the enhanced HIPC and MDRI initiatives.

18. External non-project financing needs are estimated at about \$3 million in 2006. This is expected to be covered by budget support grants and debt service relief. Shortfalls will be addressed primarily through a reduction in the clearance of past domestic arrears and, if necessary, postponement of less essential spending. The authorities believe that successful implementation of the SMP and an eventual PRGF arrangement will serve as a catalyst for a further increase in foreign assistance, in line with pledges during the December 2005 donors' conference, and eventual debt relief. This will be critical for bringing Comoros's debt burden down to a sustainable level and free resources for much-needed social and development spending.

G. Program Monitoring

19. To monitor performance under the extended SMP, quantitative indicative targets have been set of end-March and end-June 2006. These concern (a) the domestic primary fiscal balance; (b) government domestic revenue; (c) the government wage bill; (d) expenditures made by cash advances; (e) domestic expenditure arrears; (f) contracting or guaranteeing nonconcessional government external debt; (g) short-term external debt, and; (h) accumulation of new public sector external arrears to multilateral institutions (Table 1). Structural indicative targets have also been established (Table 2).

20. To assess progress in implementing the program, the IMF staff and the authorities of the Union of the Comoros will jointly review progress under the SMP in June 2006. If performance is in line with quantitative indicative targets as of end-March (and if preliminary data for April and May indicate that the end-June targets are likely to be met) and if good progress is made in implementing the structural benchmarks specified through end-June, the government would like to reach understandings on a PRGF-supported program with the IMF, with a Board meeting in the third quarter of 2006 and the program period to commence on July 1, 2006.

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

	2006		Dec Indicative targets
	March	June	
	Indicative targets under the SMP		
(a) Floor on the domestic primary balance	105	936	1,373
(b) Floor on total domestic revenues	4,650	11,600	24,400
(c) Ceiling on the wage bill	3,300	6,500	12,799
(d) Ceiling on expenditures made by cash advances (without prior budget commitment)	100	200	400
(e) Ceiling on the net accumulation of domestic arrears	0	0	-700
(f) Ceiling on new nonconcessional external debt contracted or guaranteed by the State 2/	0	0	0
(g) Ceiling on new short-term external debt contracted or guaranteed by the State 2/	0	0	0
(h) Ceiling on accumulation of debt service arrears towards multilateral creditors	0	0	0

1/ Definitions of the indicative targets and adjusters are provided in the Technical Memorandum of Understanding (TMU), see IMF report EBS/05/19, Appendix II.

2/ Excluding trade credits.

Table 2. Structural Indicative Targets and Other Structural Measures for 2006

Sector	Measure	Time Frame
Structural Indicative Targets for January - June 2006		
Budget reform	Establish accounting unit to compile and consolidate budget execution data from the union and island governments	April 2006
	Conduct monthly meetings of the budgetary committee comprising representatives of the union and all three islands	continuous from April 2006
	Start issuing monthly reports on budget execution by the union and islands to all ministries of finance, within 45 days after the end of each month	continuous from April 2006
	Start issuing monthly reports on public external debt service by creditor to the union ministry of finance (with breakdown of amortization and interest accrued and paid)	continuous from April 2006
	Start compiling on a quarterly basis social expenditures for union and island governments, within 2 months after the end of a quarter	continuous from May 2006
Revenue reform	Create a large taxpayers unit responsible for registration, management, arrears collection and audit of all large enterprises on the three islands	April 2006
	Perform a census of enterprises with revenues above CF 20 millions on the three islands	April 2006
Private sector development	Submit investment law to parliament that includes the introduction of a one-stop shop for investors and provides for legal procedures that give investors recourse to the courts.	April 2006
Other Structural Reform Measures for 2006		
Budget reform	Adopt template for a new chart of accounts for the public sector	Sep 2006
	Report arrears by economic type and keep an auxiliary recording of actual cash payments by major category	continuous from Oct 2006
	Implement the new budget nomenclature for the health and education sectors	Dec 2006
Revenue reform	Begin reporting of detailed monthly customs data of each island to the general customs directorate	Sep 2006
	Computerize all tax offices	Dec 2006
	Extend pre-shipment inspections to all islands	Dec 2006
Expenditure reform	Complete computerization of civil servant payment roster and staff the administration to monitor and control wage payments	Dec 2006
	Adopt organic frameworks for union and island ministries	Dec 2006
Statistics	Restructure the statistics office to expand its responsibilities to include the compilation and dissemination of union and island-level data	Sep 2006
	Develop a multi-sector action plan for enhancing the availability of economic and social statistics	Oct 2006
Financial sector	Extend banking supervision to microfinance institutions	Sep 2006
	Update the legal and supervisory framework in light of greater competition in the banking sector	Dec 2006
Private sector development	Prepare a strategy for introducing greater competition and private sector involvement in state-owned enterprises, including for telecommunications and hydrocarbons	Sep 2006
	Adopt an action plan for addressing cross-debts of public enterprises.	Sep 2006
	Adopt an action plan to reduce financial losses of the public electricity company	Dec 2006