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DJIBOUTI

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Table of Contents

ABBREVIATIONS AND ACRONYMS

ADB	African Development Bank
ADF	African Development Fund
AEO	African Economic Outlook
AFD	African Legal Support Facility
AFESD	African Water Facility
ALSF	Arab Fund for Economic and Social Development
ANPI	Committee on Development Effectiveness
AWF	Common Market for Eastern and Southern Africa
CEN-SAD	Community of Sahel-Saharan States
CODE	Country Policy and Institutional Assessment
COMESA	Country Strategy Paper
CPIA	Department of Statistics and Demographic Studies
CRS	Djibouti Franc
CSP	Djibouti Urban Poverty Reduction Programme
DISED	East African Submarine Cable System
DJF	Economic and Sector Work
EASSy	European Rapid Operational Force
ECF	European Union
ESW	Extended Credit Facility
EU	Food and Agriculture Organization
Eurofor	Foreign Direct Investment
FAO	Fragile States Facility
FAPA	French Development Agency
FDI	Fund for African Private Sector Assistance
FSF	Global Environment Facility
GDP	Gross Domestic Product
GEF	Highly Indebted Poor Countries
HDI	Human Development Index
HIPC	Intergovernmental Authority on Development
IDB	International Monetary Fund
IGAD	Islamic Development Bank
IMF	Kuwait Fund for Arab and Economic Development
INDS	Medium Term Expenditure Framework
KFAED	Medium-Term Budget Framework
MDG	Millennium Development Goals
MTBF	National Initiative for Social Development
MTEF	National Investment Promotion Agency
NEPAD-IPPF	New Partnership for Africa's Development-Infrastructure Project Preparation Facility
OPEC	Organization of Petroleum Exporting Countries
PEFA	Public Expenditure and Financial Accountability Programme
PREPUD	Real Effective Exchange Rate.
RBCSP	Regional Integration Strategy Paper
REER	Regional Services Centres
RISP	Results-Based Country Strategy Paper
RWSSI	Rural Water Supply and Sanitation Initiative
SME	Small and Medium-sized Enterprises
SMI	Small and Medium-sized Industries
UA	Unit of Account
UNHCR	United Nations High Commission for Refugees
UNO	United Nations Organization
USAID	United States Agency for International Development
USD	United States Dollars
VAT	Value Added Tax
WEF	World Economic Forum
WFP	World Food Programme

1. INTRODUCTION

1.1 The 2011-2015 Country Strategy Paper (CSP) for Djibouti will cover the period of the Twelfth Replenishment of the African Development Fund (ADF-12) from 2011 to 2013, and part of ADF-13, from 2014 to 2016.

1.2 The previous CSP 2007-2010 focused on two pillars, namely promotion of integrated local development (pillar 1) and capacity building with focus on good governance (pillar 2). This CSP builds on lessons learnt from the previous one, which are recorded in the combined report on CSP 2007-2010 completion and portfolio performance review.

1.3 In this regard, this CSP notably strengthens selectivity around a single pillar which aims to assist the country in implementing its development strategy and concurrently permitting it to avail itself of the various funding opportunities within the Bank Group. Unlike the previous one, this CSP includes Djibouti's fragile State dimension, which is most evidenced by the low institutional capacity and human resources.

1.4 The CSP is consistent with the country's national development strategy which is contained in the revised National Initiative for Social Development (INDS) 2011-2015. It also takes into account the various consultations held with the Djibouti authorities and other stakeholders, as well as the conclusions of the consultation workshop held in May 2011.

2. COUNTRY CONTEXT AND OUTLOOK

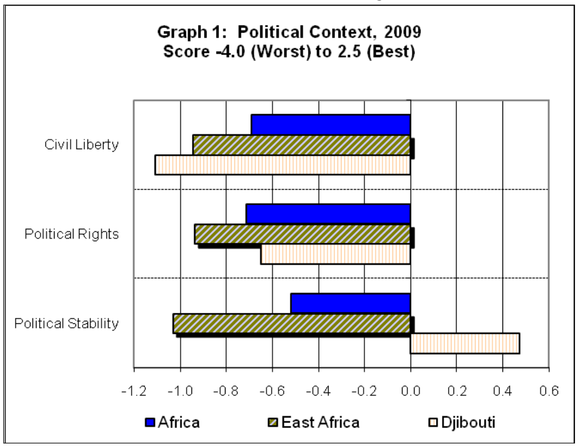
2.1 Political, Economic and Social Context

2.1.1 Political Context

2.1.1.1 Located in a conflict-prone region, Djibouti has been marked by a decade-long period of political stability (see Chart 1). President Ismaël Omar Guelleh, who has been in power since 1999, was re-elected with a strong majority for a third term on 8 April 2011. He was able to stand for election thanks to a constitutional amendment passed in April 2011 which raised, from two to three, the number of terms a president may serve. His candidature was decried by the opposition, leading to popular protest in February 2011 in the wake of the events which occurred earlier this year in the Arab world.

2.1.1.2 The opposition is still fragmented, and often boycotts elections it deems irregular and condemns political repression. In response to demands for change, about half of the new government is composed of technocrats, who are new on the political scene.

2.1.1.3 At the regional level, Djibouti maintains good relations with Ethiopia. It played a significant role in Somalia by hosting discussions that led to the Djibouti Agreements of August and December 2008 establishing the Transitional Federal Government of Somalia. However, the country experienced a border conflict with Eritrea between 2008 and 2010 concerning Ras and Doumeira Island. The conflict was resolved through the mediation of Qatar. The process of demarcating the border between the two countries is under way.



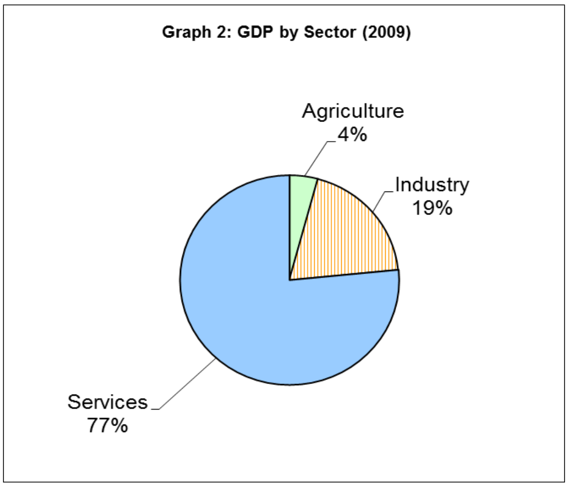
Source: ADB Statistics Department using data from the WEF, 2010

2.1.2 Economic and Social Context

2.1.2.1 **Economic Structure and Growth Engines:** Djibouti has a dual economy comprising a modern sector based on revenue from service activities which coexists with a large informal sector. Revenue is derived from the ports, as well as from the foreign military bases and contingents established in the country, principally due to its geostrategic location.

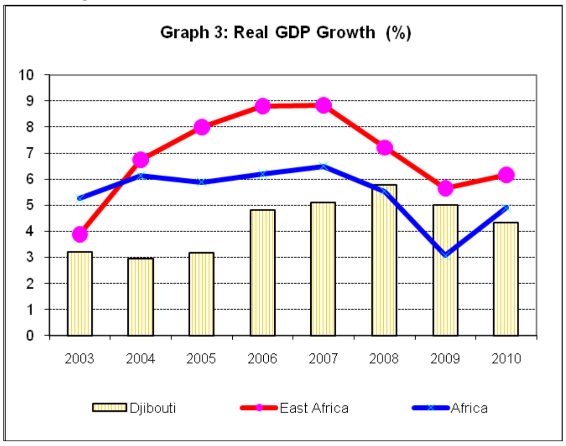
2.1.2.2 **The economy remains undiversified and highly informal.** The tertiary sector dominates with 76% of GDP (see Chart 2), and employs 60% of the working population shared between transport, communication, trade, tourism and banking activities. The tertiary sector is mainly composed of by port activities and those related to trade, handling and logistics services. The informal sector constitutes the livelihood of a large part of the population.

2.1.2.3 This dual situation is due to the major change experienced by the country since 2003 following the massive influx of foreign direct investments (FDI). These are mainly from the Gulf States, and are directed towards capital-intensive sectors, which create only few jobs. The FDI is part of a long-term strategy of the authorities aimed at making Djibouti a regional platform for commercial, logistics and financial services.



Source: ADB Statistics Department.

2.1.2.4 The **real growth rate of the Gross Domestic Product (GDP)** was sustained during the 2007-2010 period (averaging 5% per year, see Chart 3), despite the financial crisis. This growth was strongly driven by port activities and FDI flows into the country.



Source: ADB Statistics Department, African Economic Outlook, April 2011

2.1.2.5 Economic growth is expected to accelerate in 2011 and 2012 as a result of FDI carried forward from 2009 and 2010, as well as recovery of port activities, particularly trans-shipment. Port activities, which consist mainly of trade in oil and dry cargo destined for Ethiopia or for trans-shipment, declined in 2009 as a result of the financial crisis. The decline was more significant in trans-shipment activities which had dominated the container traffic previously.

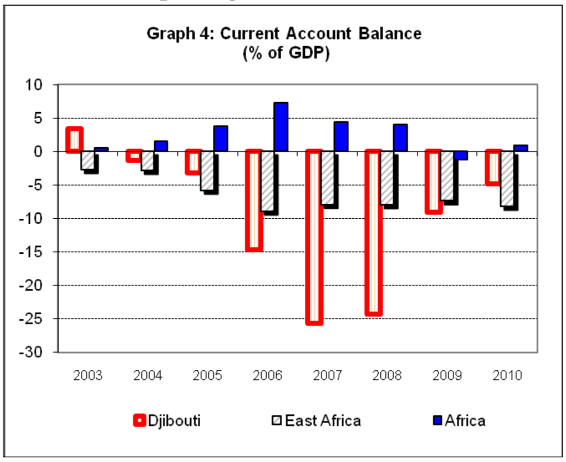
2.1.2.6 **Macroeconomic Management:** The Government is striving to pursue prudent macroeconomic management within the context of the three-year programme supported by the IMF Extended Credit Facility (ECF) of 20 million dollars approved in September 2008.

2.1.2.7 The **budget deficit** has generally been brought under control, except for the slippage in 2009, which led to postponement of the second and third ECF reviews. Increased military spending due to the conflict with Eritrea, as well as social spending to ensure food security led to a deficit of 4.6% of GDP, as against the programme's 2009 target of 1.8% of GDP. In 2010, the budget deficit stood at 0.6% of GDP, thanks to Government efforts to restore balance in public finance, thereby allowing for the conclusion of the second and third

ECF reviews in December 2010. The fourth review was concluded in June 2011. The Government intends to balance the budget in 2011, while maintaining social spending.

2.1.2.8 **Inflation** remains sensitive to rising prices of food and oil products, which are the country's main imports. Despite the acceleration in 2010, inflation has remained under control at an annual price increase rate of 3.9%, mainly driven by rising food prices. The Government intends to maintain its policy of subsidising food and oil prices to mitigate the impacts of an increase in prices on the population's purchasing power.

2.1.2.9 The **trade balance** has a structural deficit. Exports are low in comparison to the country's imports, which are mainly oil, food items and capital goods.



Source: ADB Statistics Department, African Economic Outlook, April 2011

2.1.2.10 The **current account** structural deficit (see Chart 4) continued to shrink in 2010, diminishing from -9.1% of GDP to -4.8% of GDP between 2009 and 2010. This trend stems from a decline in capital goods imports following a decrease in FDI from USD 198 million in 2009 to USD 75 million in 2010. Over the past few years, the FDI has helped to maintain a positive capital account balance, which contributed to a surplus balance of payments amounting to USD 9 million in 2009 and 2010.

2.1.2.11 The **external public debt** stood at USD 634 million in 2010. As a percentage of GDP, it declined slightly between 2009 and 2010, from 60% to 56.1%. However, the levels are still high and force authorities to refrain from non-concessional borrowing[1]. Djibouti has not been declared eligible for the HIPC Initiative and, as such, could not benefit from debt relief. Opportunities for debt relief outside the HIPC initiative are limited, particularly due to the fact that 66% of the debt is owed to multilateral creditors. Bilateral creditors are owed the remaining 34%, notably the Paris Club (12%), Kuwait and Saudi Arabia.

2.1.2.12 In October 2008, part of Djibouti's debt with the Paris Club creditors was however restructured. On the basis of the treatment comparability clause, bilateral agreements were signed with Saudi Arabia. Negotiations have been initiated with the United Arab Emirates and Kuwait. Given the substantial investment needs, Government policy aims to increase internal resources, as well as seek grants and concessional loans to ensure sustainability of public finance.

2.1.2.13 **Governance:** Assessments under the CPIA and other rankings (Ibrahim Index or Transparency International) highlight significant challenges in governance. In general, the country suffers from the adverse effects of inefficient and low quality public services.

2.1.2.14 The CPIA "governance" factor rating on efficient management of the public sector and institutions has remained at the score of 3 since 2005 for most of its sub-components, except for the one on efficiency of resource mobilisation. The sub-components relating to property rights, quality of budget management and bureaucracy, as well as to transparency, accountability and corruption continue to pose enormous challenges.

2.1.2.15 Executive power is concentrated, and exerts influence on the judiciary. The media is largely owned by the State, and is subject to censorship.

[1] See Annex VII on Debt Sustainability Analysis.

2.1.2.16 The conclusions of PEFA diagnosis, conducted in 2010, highlight weaknesses in budget preparation, execution and control. In particular, it mentions that 51% of public contracts in 2009 were awarded following non-competitive procedures. It should be noted, however, that a new public procurement code was adopted in July 2009.

2.1.2.17 In 2011, the Bank will conduct a review of the national procurement rules and procedures in Djibouti, with a view to exploring possibilities of applying the provisions of the Paris Declaration on the use of country procedures in project implementation.

2.1.2.18 As regards domestic resource mobilization, the country made progress, with the institution of VAT in 2009 so as to adopt the COMESA Common External Tariff within the context of a single market. The IMF recommended the modernization of the tax administration and improvement of tax collection. Measures will be taken to simplify the tax system and broaden the tax base, particularly through a new customs code, decentralised payment centres or lowering of the VAT liability threshold.

2.1.2.19 The **competitiveness** of the economy, as reflected by the real effective exchange rate (REER), has been on the decline since 2008. Indeed, it increased by 7% in 2008-2009 and by 4% in 2010.

2.1.2.20 **Business Environment:** According to the *2011 Doing Business* report, published by the World Bank, Djibouti ranked 158th out of 183 countries, dropping by one place from the previous year, 2010. The country performed well in foreign trade activities, but dropped by 22 places with respect to payment of taxes, due to an increase in the number of payments and the time required.

2.1.2.21 The Authorities have embarked on improving the regulatory framework for private sector promotion. The creation of a one-stop shop to facilitate procedures and promote business creation is a major contribution of the National Investment Promotion Agency (ANPI), which was set up in 2001. In 2010, the Investment Code was revised and adopted by the National Assembly, as well as other legal instruments governing companies and bankruptcy procedures. The Labour Code has been revised. In addition, Djibouti has a free trade zone, the Djibouti Free Zone, which grants fiscal, administrative and logistical incentives to facilitate trade, involving importation, storage, processing and re-export of goods.

2.1.2.22 However, doing business is still stifled, particularly by poor investor protection, difficulty in obtaining credit or lengthy procedures for creating businesses. Entrepreneurs still face high production factor costs in addition to the problem of access to energy and water supply, skilled labour and telecommunications.

2.1.2.23 **Regional Integration and Trade:** The Government's goal is to make Djibouti a trading and services platform for the region. Djibouti is a member of the Common Market for Eastern and Southern Africa (COMESA). Within that context, the country made efforts towards harmonization, particularly with the institution of VAT in 2009 (see section 2.1.2.18 above). Djibouti is also a member of the Community of Sahel-Saharan States (CEN-SAD) and the Intergovernmental Authority on Development (IGAD), whose headquarters it hosts.

2.1.2.24 Ethiopia, the main trading partner of the country, accounts for 80% of transit goods. Djibouti is currently negotiating trade agreements with Kuwait, Kenya, Turkey, Saudi Arabia, China and France. The development strategy for Doraleh Port will help to enhance the role of regional integration in the country's economic growth. The country seeks to become an important partner for trading activities with the newly independent State of South-Sudan.

However, efforts are still required with respect to non-tariff barriers.

2.1.2.25 Furthermore, the energy sector offers great opportunities for strengthening regional integration. The Bank has already financed an electricity interconnection network between Djibouti and Ethiopia. The tapping of Djibouti's geothermal potential in conjunction with other countries of East Africa (Kenya, Ethiopia, Eritrea, Uganda and Tanzania) is another area for strengthening integration in clean energy development.

2.1.2.26 **Social Context and the Millennium Development Goals (MDGs**). Although significant efforts have been made in investments in the social sectors since 2007 when the country entered a period of sustained economic growth, Djibouti is a country with low social indicators, and a Human Development Index (HDI) ranked at the 147th position out of 169 countries in 2010. Moreover, poverty remains endemic in the country. This situation stems from a series of political crises, regional wars and a national armed conflict between 1984 and 1995, compounded by economic shocks arising mainly from drought. These events affected both the country's competitiveness and its key social indicators.

2.1.2.27 Data from 2002 showed that **poverty** affected 74.4% of the population, of whom 42.2% were in a situation of extreme poverty. The poverty survey conducted in 2006 confirmed the structural and widespread nature of poverty revealed in 2002. This situation still prevails today. Indeed, spot and specific estimates reflect the still endemic nature of poverty in the country, fuelled by rising food prices, widespread unemployment and spells of severe drought.

2.1.2.28 A household income and expenditure survey, funded by the Bank under the PREPUD Project, is scheduled for September 2011. It will help to update the data and carry out further studies on poverty.

2.1.2.29 Furthermore, the country is hosting a refugee population estimated in January 2011 at 16 520, mostly from Somalia, according to the UNCHR. The country also faces a constant influx of people because Djibouti serves as a transit point for migration to the Middle East or other countries. This increases the pressure on basic social services.

2.1.2.30 Despite the progress made, the population has limited access to **basic social services**. Health indicators are relatively low. Health coverage is low, with two doctors for 10,000 inhabitants. Life expectancy is limited, standing at 56 years in 2010. The maternal mortality rate is high, with 300 cases per 100 000 births in 2009. The mortality rate of children under five years was 93 per 100,000 in 2006. Regarding access to drinking water and sanitation, only 40% of households are connected to the water supply network, and 25% to the collective sanitation network.

2.1.2.31 Furthermore, living conditions remain precarious, with only 45% of households living in dwellings with solid material walls. Progress has been made in the field of education. The gross primary enrolment rate was 74% in 2009 as against 39% in 2000. The girl/boy ratio registered a slight improvement with an increase from 0.8 in 2001 to 0.89 in 2009. In the intermediate cycle, the gross enrolment rate was 50% in 2009 as against 19% in 2000. This resulted in a sharp increase in the literacy rate in the 15-24 age group, reaching 79% in 2009 as against 46% in 2002. However, the quality of education remains inadequate. It is marked by a low primary completion rate, high rates of teacher absenteeism, and overcrowded classrooms.

2.1.2.32 This precarious social situation is reflected in the low level of achievement of the **MDGs**. MDG 2 on universal primary education could be achieved by 2015, followed by those related to reducing child mortality (MDG 4) and the promotion of gender equality (MDG 3). The probability of achieving the other goals is low, particularly MDG 1 on eradicating extreme poverty and hunger where the probability of achievement by 2015 is almost zero, unless efforts are made in targeting. Progress at this level will be conditioned particularly by a result-based public finance management and an appropriate monitoring and evaluation system that are currently lacking.

2.1.2.33 **Gender Equality:** The State's desire to improve the status of women has led to the adoption of a national strategy for integrating women in development in 2002. This was enhanced by the development of a master plan for 2009-2013. However, the empowerment of women is still limited, with a literacy rate of 47% for women aged 15 to 49 in 2010. Despite the development of microfinance, the employment rate for women was 12% in 2010. Finally, the representation of women in decision-making is low with a ratio of 10% in Government and 14% in Parliament.

2.1.2.34 **Environmental Context:** According to the *Disaster Risk Profile* developed by the World Bank, Djibouti is vulnerable to the following natural disasters: (i) extended multi-year periods of drought that result in the scarcity of water for agriculture and domestic use; (ii) frequent flash and intense floods; (iii) frequent earthquakes originating from the volcanic area along the Assal Rift; and (iv) wildfires fuelled by drought and exacerbated by unstable building materials. This environmental context increases the vulnerability of the population, 33% of whom live in areas considered to be at high risk.

2.2 Strategic Options

2.2.1 Country Strategic Framework

2.2.1.1 **The National Initiative for Social Development (INDS)** outlines the Government's development and poverty reduction strategy. It was originally defined in 2007 for the 2007-2009 period around four strategic areas: (i) growth, competitiveness and employment; (ii) access to basic social services; (iii) reducing poverty and vulnerabilities; and (iv) public governance. It is regularly updated on a rolling basis, while maintaining the four strategic areas.

2.2.1.2 The first area focuses on the consolidation of growth, increased competitiveness and job creation. The second area seeks to develop human capital through broader access to quality social services (health, education, water, food security, employment). The third focus area aims to reduce extreme poverty and inequality, while mitigating social and environmental vulnerabilities. The fourth focus area seeks to promote good local, economic and financial governance, capacity building for economic planning and management as well as modernization of the administration and its tools and resources.

2.2.1.3 The outcomes of **INDS implementation** are mixed. Despite sustained economic growth, driven in particular by investments in infrastructure, little progress has been made in combating poverty. This is due to: (i) the concentration of FDI in capital-intensive activities that create only few jobs; (ii) the lack of selectivity and prioritization of actions in the four focus areas of the strategy; (iii) the partial funding of the strategy; and (iv) the lack of a monitoring and evaluation system based on an appropriate result framework.

2.2.1.4 An assessment of the previous INDS (2008-2012) shows that out of the 454 priority actions identified, only 20% were completed, 50% are in progress, and 30% have not yet started. The resources mobilized covered 54% of funding requirements estimated at USD 1.6 billion.

2.2.1.5 The absence of a planning and programming system supported by results-based management of public finance also accounted for the limited effectiveness of the INDS. Indeed, there is no connection between spending by the various ministries in the social sectors and the expected outcomes of the INDS in the fight against poverty, despite the fact that 50% of the State budget is devoted to social spending. This is due to the fact that INDS strategic priorities are not factored into the budgetary process.

2.2.1.6 Besides, the lack of monitoring and evaluation mechanisms, both at central and sector levels, does not allow for measurement of the status of activities implemented or assessment of their performance against set targets. These difficulties are compounded by the acute inadequacies of the national statistical system, particularly as regards collection and regular production of reference data for both project monitoring and macro-economic management and planning.

2.2.1.7 **The current INDS is that revised for 2011-2015**. Its highlight lies in an effort to prioritize activities by sector. Priority actions have been reduced from 450 to 100, on the basis of feasibility criteria and impact on key development indicators. However, the establishment of an appropriate monitoring and evaluation system is a major challenge, especially as concerns finalizing the choice of indicators, the availability of baseline data, as well as their regular production, monitoring and evaluation.

2.2.2 Challenges and Constraints

2.2.2.1 Poverty and unemployment are the major challenges facing Djibouti. The main constraints confronting the country are: (i) water shortage; (ii) food insecurity; (iii) shortage of energy; (iv) lack of economic diversification; and (v) weak institutional capacity.

2.2.2.2 **Endemic Poverty and Unemployment:** Although no recent survey has been conducted on poverty, specific studies on living conditions indicate that large segments of the population live in a situation of marginalization and extreme poverty, with a worrying level of unemployment. (see sections 2.1.2.26 to 2.1.2.32).

2.2.2.3 The difficulties encountered in living conditions, arising mainly from lack of water and food insecurity, have led to a concentration of 70% of the population in urban areas, 47% of whom do not have enough income to afford a satisfactory diet.

2.2.2.4 The employment survey conducted in 2010 shows that unemployment remains high, affecting 54% of the workforce and 70% of young people. Driven by capital-intensive activities, the sustained economic growth has not reduced the unemployment rate. The precariousness of living conditions is even worse for the poorest 20%, 63% of whom are unemployed and have no property. They live in temporary housing, and are not connected either to electricity or drinking water. For foodstuff, they spend USD 0.6 per person per day, and 53% of them suffered from hunger over the past 12 months.

2.2.2.5 Low economic diversification limits job opportunities in sectors with high potential for labour utilization, such as agriculture or industry. Labour productivity is low because skill levels are either low or inappropriate for the needs. The constraints on the business environment limit exploitation of the potential for self-employment in the country.

2.2.2.6 **Water Shortage:** The low availability and mobilization of water resources limits access to drinking water and sanitation. It hinders the development of agricultural and economic activities in general. The annual production of drinking water is only 15 million cubic metres, while demand is estimated at about 30 million. Despite progress in recent years in access to drinking water, a significant portion of the population remains uncovered and at risk of recurrent drought in the country.

2.2.2.7 Access to water remains a major challenge for the country both in terms of public health and the development of socio-economic activities that would enable settlement of the population outside the capital. To this end, the mobilization of surface water is a Government priority. Pilot projects have been initiated, with the support of the Bank particularly under the Surface Water Mobilization Studies Project.

2.2.2.8 There is structural **food insecurity** in the country, which produces only 10% of its food needs and imports the remaining 90%. This situation stems from the arid climatic conditions and low development of agriculture and fisheries, and is worsened by prolonged periods of drought. Some 31% of the population suffers from undernourishment. The proportion of malnourished children is 33%, which is one of the highest rates in the world. The poorest households spend nearly 80% of their consumption expenditure on food.

2.2.2.9 Djibouti is also affected by the current food crisis in the Horn of Africa caused by drought. The UN launched an appeal for funds to the tune of USD 21 million to provide humanitarian assistance to 120,000 people in highly vulnerable situation. The Bank is supporting international community efforts to solve the food crisis with emergency assistance of USD 1 million.

2.2.2.10 The underdevelopment of the agricultural sector is also due to the small size of developed lands and non-mastery of irrigation techniques. The Government's food security strategy is aimed at: (i) first, developing agriculture in countries of the region, particularly Ethiopia and Sudan, to create a buffer stock of food; and (ii) secondly, developing arable land in the country through irrigation systems and mobilization of surface water.

2.2.2.11 The under-exploitation of fishery resources is due to the limited number of boats, non-mastery of appropriate fishing techniques and low level of training of fishermen. The development of these resources would also help to reduce food insecurity and rural exodus, which is the cause of a high concentration of population in Djibouti City.

2.2.2.12 **Energy Constraint:** The energy constraint results in limited supply and high cost, which hinders private sector development. The constraint also affects water availability. The price of electricity per kilowatt/hour is 30 US cents for the social tranche and around 40 cents for industries. Total electricity production capacity is estimated at about 98.8 megawatts, supplied by oil-fired generators. The obsolescence of production facilities, combined with heavy network losses, reduces the effective availability to 57 megawatts, which is below the estimated demand of 75 megawatts in 2010.

2.2.2.13 The electricity transmission line connecting Djibouti and Ethiopia, funded by the Bank, is expected to be commissioned in 2011. It will help to significantly reduce the energy constraint through the importation from Ethiopia of between 180 and 700 gigawatt-hours of electricity per year, depending on availability. There exists a scope for reducing the price of electricity. The pricing agreement signed in March 2011 between the two countries provides a rate ranging from 6 to 7 US cents per kilowatt hour depending on the hour and the season. The Government is considering an observation period of about one year to review sustainable rate-reducing conditions.

2.2.2.14 **Lack of economic diversification:** The economy is heavily concentrated in the service sector, mainly port activities as discussed above. In contrast, the secondary sector is highly underdeveloped, contributing around 16% to GDP, although it has experienced relative growth driven mainly by the construction sub-sector and the establishment of some building hardware and mineral water industries. The primary sector is marginal.

2.2.2.15 The weaknesses of the statistical system limit analysis of economic activity. The few censuses conducted are partial. However, they reveal a restricted, highly informal economic base in which major employers, with more than 500 employees, are public institutions: Djibouti Electricity, Djibouti Telecom, Port Authority, and National Water and Sanitation Authority.

2.2.2.16 Informal enterprises are estimated at about 60% of business activity. They are mostly individual units, loosely structured and concentrated in trade, import-export, construction and miscellaneous services. The high cost of factors, especially water and energy, hinders economic diversification and development of SMEs/SMIs. However, they are potential sources of job creation. Their development would help to boost the economic fabric, reduce unemployment, and provide more inclusive growth.

2.2.2.17 **The weak institutional capacity and human resources** in the country is a major challenge. The Government recognizes the need to strengthen transparency and efficiency of public spending. Aware of the strong social demand for quality public services, it has made the modernization of public management a fundamental pillar of its strategy to develop the country.

2.2.2.18 Overall, weak capacity largely characterizes the nature of Djibouti's fragility. It also underscores the importance of a holistic approach to the need for capacity building for the State. In this respect, and learning from the previous CSP, the Bank in December 2010 conducted a diagnosis of public finance, as well as monitoring and evaluation of the INDS in order to identify priority needs for capacity building.

2.2.2.19 The diagnosis particularly highlighted: (i) the virtual absence of a national monitoring and evaluation system and the extreme weaknesses of the statistical apparatus; (ii) the failure to formulate and standardize budget performance procedures; and (iii) the disconnect between the strategic priorities of the National Initiative for Social Development (INDS), budget allocations, and expenditures by sector ministries. These institutional weaknesses account for the inefficiency of State intervention in the fight against poverty despite the substantial public spending in social sectors and sustained economic growth.

2.2.2.20 The study underscores the need for Djibouti to move from a resource-based budget process to a results-based method of economic and public finance management, with a view to increasing the effectiveness of INDS implementation in terms of the impact on poverty.

2.2.2.21 The diagnosis supplements the PEFA assessments, the World Bank's public expenditure review, and the various IMF assessments, including the one relating to the introduction of a medium-term budgetary framework. It is a useful tool for guiding the Bank's actions, and serves as a platform for dialogue and coordination with the other stakeholders. This holistic approach is aimed at ensuring the effectiveness of interventions and the achievement of results.

2.2.3 Strengths and Opportunities

2.2.3.1 The country's strengths and opportunities lie in its: (i) geo-strategic position; (ii) capacity to attract FDIs; (iii) recent developing financial sector; (iv) geothermal potential; and (v) natural, mining, tourism and fishery resources.

2.2.3.2 **The geostrategic location** of Djibouti in the Gulf of Aden, on major commercial corridors for the maritime transportation of goods and oil between Asia and Europe, is its most significant advantage. This position also explains why the country is host to several foreign military bases. The instability in neighbouring coastal countries strengthens the country's position as the main entry point for goods, intended particularly for the large Ethiopian market.

2.2.3.3 The authorities have taken advantage of this strategic position by deciding to make the country a hub for trade and services in the region. To that end, huge investments have been made in port, roads, hotels and telecommunications infrastructure. The country now has modern infrastructure, including a bulk carrier port, a container terminal, an oil port and a link to the EASSy submarine fibre-optic cable, which serves 20 coastal or landlocked countries in East and Southern Africa. This latter advantage could be strengthened by a policy to liberalize the telecommunications sector.

2.2.3.4 **Capacity to attract FDI**s. FDI flows to the country have enabled Djibouti to achieve sustained economic growth over the past decade. Until now, FDIs have had the common feature of coming from Gulf countries, with a concentration in capital-intensive activities (see Annex III). They began to soar as from 2003, the year they reached the sum of DJF 2,528 million, compared to DJF 610 million in 2002, and peaked at DJF 44,963 million in 2008. This momentum slackened with the postponement of certain investments during the global financial crisis. However, FDIs are expected to pick up afresh.

2.2.3.5 The FDIs benefit from a favourable tax environment created by the tax exemption policy of the investment code and the free trade zones. Tax exemptions are expected to be streamlined in the coming years without, however, withdrawing the exemptions previously granted.

2.2.3.6 **Recent developments in the financial sector:** The financial sector continues to expand with the arrival of two new banks in 2010, bringing to 11 the number of banking institutions in the country, compared to only two in 2006. The sector is buoyed by the favourable foreign exchange system, since the currency is pegged to the dollar under the currency board regime prevailing in the country since 1949.

2.2.3.7 The free convertibility of the Djibouti franc, the absence of foreign exchange controls, and the free movement of capital are also pull factors. The new banks have carved out niches for themselves, including the introduction of Islamic banking or account opening for small savers. However, the sector remains highly concentrated, with the two major banks holding 85% of the assets.

2.2.3.8 The banking sector is very liquid, with a low level of non-performing loans, standing at about 6% in 2009. There is potential for the banking system to increase credit to the private sector. Currently, only 20 to 25% of the funds collected is re-injected as credit and the rest is invested abroad. SMEs/SMIs receive only 5% of the funds allocated to enterprises despite the project opportunities available to banks. This is due to the banks’ aversion to risks and the difficulty of calling up security in the event of a default.

2.2.3.9 The adoption of a policy to facilitate access by enterprises to domestic credit would leverage their growth and the employment-generating potential of SMEs/SMIs.

2.2.3.10 An IMF analysis of the financial sector estimates that systemic risk is low. However, the authorities have, under the aegis of the IMF, initiated reforms to strengthen banking supervision and regulation. The aim is to prevent the risk of money laundering or terrorist financing. There are also plans to raise the minimum capital required for opening a bank and reduce the granting of licenses in an effort to sustainably regulate the sector’s expansion.

2.2.3.11 **Geothermal Potential:** Located at the intersection of three tectonic plates, Djibouti has a huge geothermal potential like some other East African countries as discussed above.[2] The tapping of this potential would help to remove the energy constraint. However, the operation is hampered by the high cost of drilling-based exploration. The Government has already raised funds from a number of donors, including the Global Environment Facility (GEF), OPEC and the World Bank to begin the drilling. It has also appealed to the Bank for a contribution, in the event of a financing gap.

2.2.3.12 The objective is to determine the quantity of the resource and confirm the possibility of its effective use for geothermal electricity generation. Djibouti's geothermal resources can provide opportunities for strengthening regional integration and public-private partnership. In the Eastern Africa Regional Integration Strategy Paper (RISP), the Bank plans to provide assistance for the adoption of a regional approach, including the development of a master plan, a harmonized framework for policies, regulations and investment, capacity building, project financing and the mobilization of resources for global climate change and the private sector.

2.2.3.13 **Natural, mining, tourism and fishery resources**: Djibouti has untapped mineral resources such as salt from Lake Assal, whose potential is estimated at 1,200,000 tonnes per year, perlite deposit and also gold. Perlite reserves are estimated at 23 million tonnes. Research is ongoing to prospect for gold and petroleum. The country's tourist attractions have not been adequately developed, although initiatives have been undertaken to open up the sites. The major attractions are: Lakes Assal and Abbot, the Day forest, the Goubet, and the Seven Brothers, Moucha and Maskali Islands.

2.2.3.14 In addition, Djibouti has a 372-km-long coastline that abounds in fishery resources, with an estimated exploitable potential 47,000 tonnes per annum. The fisheries sector remains underdeveloped. Only 4.2% of the potential, or 2,000 tonnes per year, is exploited.

2.3 Aid Coordination and Harmonization and the Bank's Positioning: Recent Developments

2.3.1 Aid Coordination and Harmonization

2.3.1.1 Donor assistance to Djibouti accounts for about 5% of GDP. The country suffers from poor coordination and harmonization of donor intervention. This is due to the lack of a national aid coordination mechanism and the limited donor representation in the country. The project-approach is predominant in the design and implementation of aid programmes.

2.3.1.2 There are ongoing efforts between the Government and several donors present in Djibouti to establish an aid coordination mechanism in the country (see Box 1). The Bank participates in the discussions, and plans to take an active part in the mechanism that will be jointly defined, in line with its positioning in the country, especially in infrastructure and the private sector.

2.3.1.3 The areas of intervention of the key multilateral development partners are as follows: (i) **IMF**: macroeconomic management and public finance, banking regulation and supervision; (ii) **World Bank**: energy, water, education and social protection; (iii) **European Union**: water, energy and food security; (iv) **FAO** and **WFP**: agriculture and food security; (v) Arab Fund for Economic and Social Development (**AFESD**): water and energy infrastructure, as well as low-cost housing and the primary sector; and **IDB**: energy and road infrastructure for the social sectors, especially education.

[2] The Rift Valley has an untapped geothermal potential of over 7,000 MW.

2.3.1.4 With regard to bilateral donors, the Kuwait Fund for Arab and Economic Development **(KFAED**) finances mainly infrastructure projects; the French Development Agency **(AFD**) focuses its action on urban development, including access to water and sanitation; **USAID** is present in the health and education sector; and China is funding road infrastructure projects and telecommunications.

2.3.2 Positioning of the Bank in the Country

2.3.2.1 The Bank's active project portfolio in Djibouti comprises seven projects. The amounts committed total UA 110.85 million, broken down as follows: (i) social (10%), through the Urban Poverty Reduction Project (PREPUD) and the Education Project which ends in 2011; (ii) water and sanitation (7%), through the Djibouti City Sanitation Project, co-financed with the EU, and the Surface Water Mobilization Project; (iii) energy (30%), through the Ethiopia-Djibouti Multinational Electricity Interconnection Project, to be commissioned this year, and (iv) the private sector (53%), through two port infrastructure projects (the Doraleh Bulk Carrier Terminal and Container Terminal). The Bank is also providing the country with technical assistance in contract negotiation through the African Legal Support Facility.

2.3.2.2 Overall, the Bank Group is mostly active in the infrastructure sector, which accounts for 90% of its activities across all windows (ADF and ADB for the private sector) and, to a lesser degree, in the social sector (10%).

2.3.2.3 Despite the relatively low ADF country allocation for Djibouti, the Bank has managed to leverage its intervention capacity in the country over the period 2007-2010 by: (i) using resources mobilized internally through the ADB private sector window, the allocation for regional operations and other internal facilities such as the AWF and emergency aid; and (ii) co-financing projects with other donors, including the EU in the water and sanitation sector and the World Bank as part of urban poverty reduction project (PREPUD). This CSP intends to sustain this approach.

Box 1: Recent Developments in Aid Coordination

Several donors recently initiated, in coordination with the Government, the preparation of a roadmap for establishing an aid coordination mechanism in the country. Initially, the mechanism was to focus on three priority areas, namely water, energy and food security.

The objectives are: information sharing and harmonization of donor interventions, with a view to enhancing aid effectiveness and helping the country better manage its debt levels now deemed critical.

It is hoped that the mechanism will help to: (i) identify priority projects; (ii) strengthen existing national programmes; (iii) provide better internal oversight and supervision capacities; and (iv) serve as a catalyst for mobilizing funds and conducting often problematic activities, including project monitoring, evaluation and auditing.

2.3.2.4 **The portfolio performance** was assessed during the combined portfolio and CSP 2007-2010 completion review mission of October 2010. It showed a slight improvement in the performance of the Bank Group's ongoing projects in Djibouti, whose overall score increased from 2.07 in 2008 to 2.16 in 2010. The portfolio disbursement rate shows a sharp increase from 26.2% to 56.5%. The average size of public sector projects also rose from UA 6.05 million to UA 8.05 million. There is currently no problem project in the portfolio, as against two in 2008.

2.3.2.5 Progress has been made in project implementation, with the average time dropping from 16 months in 2008 to 13 months in 2010, close to the norm of 12 months.

2.3.2.6 However, there are still problems, particularly regarding the communication of audit reports and their compliance with Bank standards. The overall portfolio performance is particularly constrained by the longer time frames for certain projects, including those of the social sector. The Bank's absence on the ground in a country like Djibouti, which contains elements of extreme fragility as far as capacities are concerned, also hampers its action.

2.3.2.7 Strengthening the Bank's decentralization strategy through the establishment of Regional Service Centres (RSC) will help to enhance the Bank’s effectiveness in Djibouti (see Decentralization Roadmap). Indeed, it is expected that the opening in 2012 of the Nairobi Pilot RSC, which will also serve Djibouti, will strengthen the Bank’s proximity to the country, thereby enhancing its capacity to respond to the latter's needs, in particular regarding portfolio management.

2.3.2.8 **Lessons learned:** Lessons learned from the Bank's intervention strategy in Djibouti over the 2007-2010 period are reflected in the joint report on the CSP 2007-2010 completion and the portfolio performance review. Drawing on the lessons learned, the design of this CSP has taken into account the following considerations:

(i) Selectivity is reinforced around a single pillar aligned with INDS focal areas. The pillar should address the challenges and issues facing the country regarding the improvement of living conditions, economic diversification and employment creation, in an effort to reduce poverty.

(ii) The definition of the pillar is tailored to strengthen the Bank's comparative advantage and positioning in terms of infrastructure, targeting primarily water and sanitation.

(iii) The single pillar is consistent with the available resources, including the ADF country allocation and Pillar 3 of the Fragile States Facility (FSF), and provides an opportunity to continue the successful approach initiated during the period 2007-2010 that consists in allowing the country to take advantage of the co-financing opportunities and other available Bank windows.

(iv) This CSP takes into account Djibouti's status as a fragile State, which is most evident in the country's weak capacities. In this regard, emphasis will be laid on strengthening the INDS planning, monitoring and evaluation system.

(v) This CSP recognizes the strategic importance of non-lending activities in Djibouti. Therefore, it strengthens the balance and the link between these activities and the Bank's lending programme.

2.3.2.9 As regards portfolio issues, the key recommendations contained in the Portfolio Performance Improvement Plan aim to: (i) improve project quality at entry; (ii) establish appropriate monitoring and evaluation systems; (iii) strengthen the capacity of Implementing Agencies; and (iv) adopt a more proactive portfolio management approach. The economic and sector work (ESW), the feasibility studies and the enhancement of Bank proximity through the Nairobi Pilot RSC should contribute significantly to progress.

3. BANK STRATEGY IN THE COUNTRY

3.1 Justification of Bank intervention

3.1.1.1 As earlier discussed above, the INDS constitutes the **strategic framework for the country's development**. Its implementation has certainly led to satisfactory outcomes in terms of economic growth, but has nevertheless been disappointing in terms of making significant improvements in living conditions, employment opportunities and poverty reduction. The lack of an appropriate planning, monitoring and evaluation system also limited the effectiveness of the actions of the Government and other development partners, including the Bank.

3.1.1.2 Consequently, this CSP, covering the 2011-2015 period, aims to assist the country in addressing these challenges by drawing on the strategic areas of the INDS, the lessons of the previous CSP, and the Bank's areas of comparative advantage, including infrastructure and economic governance.

3.1.1.3 The preparation of this CSP for Djibouti was also based on sustained and constructive dialogue **with the Government and other stakeholders,** particularly: (i) in October 2010 during the evaluation of the Results-Based Country Strategy Paper (RBCSP) 2007-2010 and the portfolio performance review; (ii) in December 2010 during the preparation of the needs assessment report for strengthening public finance management capacity and the INDS monitoring and evaluation; (iii) in December 2010 during the preparation of Djibouti's profile for inclusion in the 2011 issue of *African Economic Outlook*, an annual Bank publication; and (iv) in May 2011 during consultations with all stakeholders for the preparation of this CSP,[3] especially in the consultative workshop held during the mission (see Annex IV).

3.1.1.4 **Available Resources:** This CSP will cover ADF-12 (2011-2013) and part of ADF-13 (2014-2015). For the 2011-2013 period, the available resources already identified are: (i) the ADF-12 indicative country allocation amounting to UA 7.02 million, of which UA 2.34 million may be used from 2011; (ii) an amount of UA 2.5 million under Pillar 3 of the Fragile States Facility (FSF), from which Djibouti could benefit subject to the confirmation of its eligibility and the preparation of a country programming paper; and (iii) RWSSI resources of which the final amount is yet to be confirmed.

3.1.1.5 Resources that could be mobilized comprise: (i) the country allocation under ADF-13, subject to re-confirmation of Djibouti's eligibility for the ADF window; (ii) the ADB window for private sector operations (national and multinational) given the available headroom in the country's sustainable lending limit; (iii) the ADF regional allocation, subject to identification of multinational projects under the feasibility studies and the economic sector work (ESW) to be conducted during the 2011-2015 period covered by this Country Strategy Paper (CSP) and the Regional Integration Strategy Paper (RISP) for East Africa, including Djibouti; (iv) other financial instruments of the Bank, especially bilateral trust funds, the African Water Facility (AWF), the Fund for African Private Sector Assistance (FAPA), the Global Environment Facility (GEF) or the New Partnership for Africa's Development-Infrastructure Project Preparation Facility (NEPAD-IPPF). Co-financing projects with other donors is an additional leverage.

3.1.1.6 **Djibouti's eligibility for FSF-Pillar 3 resources:** With a World Bank/ADB harmonized CPIA rating of 3.06, Djibouti's eligibility for Pillar 3 of the Fragile States Facility (FSF) was determined in 2008. The country has used a total of USD 23,000 from Pillar 3 for legal technical assistance in the mining and oil sector. The Guidelines for the administration of the technical assistance and capacity building programme under Pillar 3[4] operations, approved in June 2010, confirmed Djibouti's eligibility for Pillar 3 resources with a final allocation of UA 2.5 million, to be committed before June 2012, subject to a programming document to be approved by the Bank Group's Board of Directors. The Government has submitted a request for the use of these resources.

[3] These consultations of May 2011 also afforded the Bank an opportunity to initiate the preparation of the statistical profile of Djibouti

[4] Cf. ADF/BD/WP/201044/Rev.1/Approved, ADB/BD/WP/2010/75/rev.1/Approuvé.

3.1.1.7 The previous CSP 2007-2010 was then near completion. The current CSP constitutes the required country programming document for Djibouti’s eligibility to Pillar 3 resources. In addition, when the FSF was created, the conditions for effective use of its resources, guaranteeing tangible results, were not in place. In particular, there was no needs assessment to effectively address the main causes of Djibouti's fragility, which are inextricably linked to weak institutional capacity.

3.1.1.8 Indeed, the CPIA rating for the "governance" factor, which relates to efficiency of the management of the public sector and institutions, has stagnated at the score 3 since 2005 for most of its sub-components (cf. 2.1.2.13 to 2.1.2.14).

3.1.1.9 The persistence of high levels of unemployment and poverty, affecting three-quarters of the population, is a symptom of ailment, which may be largely due to weak institutional capacity, particularly in the management of public finance and the INDS monitoring and evaluation system. This weakness is unanimously acknowledged by the Government and other development partners.

3.1.1.10 In short, Djibouti is a country in transition with the onset of sustained growth. However, it still has a serious weakness due to its low institutional capacity. This is an obstacle to significant poverty reduction. According to the FSF Operational Guidelines (ADF/BD/WP/2008/60), Djibouti can be considered as a fragile State and "in the process of gradual recovery."

3.1.1.11 Access to Pillar 3 resources will help to address the root causes of Djibouti's fragility. The Bank’s holistic and concerted approach based on needs assessment for capacity building in public finance management and INDS monitoring and evaluation will improve coordination and support dialogue with the Government and other partners so as to achieve tangible results in economic and financial governance.

3.2 Intervention Pillar

3.2.1.1 In light of the foregoing and to address the main challenges of the country, the Bank Group's strategy for assistance to Djibouti over the 2011-2015 period will focus on a single pillar: ***Strengthening socio-economic infrastructure***.

3.2.1.2 Through this **pillar**, the Bank will help Djibouti to make its growth efforts more inclusive, by establishing infrastructure especially in water and sanitation. It also aims at strengthening the capacity for Government action to promote the private sector and reduce poverty.

3.2.1.3 The **pillar** will in particular contribute to reduce the precarious living conditions of the population, who is especially confronted to a high unemployment rate and a significant water deficit. This restricted access to water and sanitation limits the development of the primary sector and hinders the growth of the private sector. This water constraint impedes economic diversification and reduces the opportunities for job creation particularly through SME/SMIs.

3.2.1.4 The pillar specific objectives are to: (i) improve living conditions by increasing access to water and sanitation; (ii) improve economic diversification and job creation by developing agricultural, fishery and market infrastructure; and (iii) improve the effectiveness of poverty reduction action by strengthening the capacities of the INDS planning, monitoring and evaluation system. This latter objective aims particularly to address the underlying and persistent causes of Djibouti's fragility in an effort to help put the country on an inclusive growth path.

3.2.1.5 The Bank Group will continue to use the wide range of financial instruments at its disposal, as discussed above and which were implemented during the previous CSP. Furthermore, unlike during the previous CSP, the Bank will strengthen its non-project activities (ESW, feasibility studies and dialogue) to enable the country to address its challenges, exploit the potential, strengthen the strategy, design and implement operations, and promote the use of various financial instruments, including in regional integration and private sector development.

3.2.1.6 The 2011-2015 CSP pillar is consistent with the country's development strategy, in that it selectively targets growth, competitiveness and employment through the promotion of socio-economic infrastructure (focus area 1), the modernization of public management, strengthening of statistical, monitoring and evaluation capacity (focus areas 2 and 6). Laying emphasis on monitoring and evaluation will help to mitigate the main constraint that has dogged the implementation of the INDS since its inception in 2007.

3.2.1.7 The pillar is also aligned with the strategy of the Bank Group's medium-term strategy focused on infrastructure, governance, private sector development and regional integration.

3.3 Proposed Operations

3.3.1.1 The **indicative lending programme** for the 2011-2015 period is provided in Annex II. For the 2011-2013 period, the indicative programme of public sector grants is as follows:

Indicative projects 2011-2013	Resources	Indicative Amounts
Institutional capacity building (2011)	Pillar III FSF	UA 2.5 mn
Infrastructure to improve access to water and sanitation in rural and semi-urban areas (2012)	ADF-12 RWSSI	UA 3 mn To be confirmed

3.3.1.2 As regards access to water and sanitation, the Bank is already involved in urban areas, with EU co-financing, under the Djibouti City sanitation project, which will be completed end-2012 or early 2013. The project will help to rehabilitate the community sanitation network and construct a new wastewater treatment plant so as to increase the connection rate of Djibouti City to the public sanitation network from 18% to about 35%.

3.3.1.3 The new operations in water and sanitation envisaged under this CSP, to be financed with ADF-12 and RWSSI resources, will help to increase access for the vulnerable population in rural and semi-urban areas. Moreover on the basis of the studies on the mobilization of surface water already conducted by the African Water Facility (AWF) and depending on the availability of ADF resources, the Bank may consider an operation in water infrastructure for a multiple use, including for domestic, agricultural and pastoral purpose. The goal is to optimize the country available water resources for an integrated use. Accordingly, between 2010 and 2015, the Bank's intervention will help to increase the proportion of households with access to drinking water supply (from 40% to 50%) and the sanitation network (25% to 35%).

3.3.1.4 The Bank's intervention in the promotion of agricultural and fishery infrastructure especially during ADF-13 is expected to reinforce the development of the primary sector, now marginal, towards diversification of economic activity, job creation and food insecurity alleviation. This operation must first be based on a comprehensive sector study.

3.3.1.5 The Bank will consider carry out, possibly under ADF-13 and in an effort to strengthen and ensure greater complementarity with this operation, a project to develop employment-generating market infrastructure, already initiated under the current Djibouti urban poverty reduction project (PREPUD).

3.3.1.6 However, these objectives cannot be achieved without enhancing Government’s efficiency in public finance management so as to optimize its expenditures and produce a tangible impact on the living conditions of the population and poverty reduction efforts.

3.3.1.7 In this regard, the Bank will finance, from FSF-Pillar 3 resources, a project to strengthen the Government's institutional capacity in planning, monitoring and evaluation of INDS. The areas and activities will be defined on the basis of the assessment of the capacity building needs in public finance management and INDS monitoring and evaluation, as well as Djibouti's statistical profile. The use of resources will be subject to a specific proposal to be approved by the Boards.

3.3.1.8 The specific objectives will, in particular, be to:

(i) strengthen the national statistics system so as to: (a) complete the processing of completed and on-going surveys and census to produce baseline data on INDS indicators; (b) produce and publish data on a regular basis;

(ii) strengthen the planning and programming system at central level and in sector ministries so as to: (a) have adequate capacity to monitor the progress of INDS priorities; and (b) assess performance against set objectives; and

(iii) strengthen the link between macro-economic management, particularly the budget, and the INDS implementation.

3.3.1.9 **Private sector operations** will draw on economic sector work (ESW) and dialogue to strengthen the intervention pillar and guide the Bank's activities towards: (i) infrastructure in the water sector and related areas; and/or, (ii) the promotion of activities, using appropriate financial instruments to reduce risk and facilitate access of SMEs to credit.

3.3.1.10 **Regional operations** will draw on the Regional Integration Strategy Paper (RISP) 2011-2015 for East Africa, the ESW and feasibility studies to be carried out between 2011-2013 by the Bank and other donors, particularly in the area of the management and mobilization of water resources and geothermal energy.

3.3.1.11 ***Non-project activities***: These include the ESW and feasibility studies (see Annex II). They will seek to increase knowledge on the country's challenges and potential, support dialogue with the country, strengthen and diversify the Bank's lending activities, particularly in the private sector, regional integration, as well as funding opportunities.

3.3.1.12 The ESW identified are: (i) private sector profile, including identification of potential sources of growth and enhancement of entrepreneurship; (ii) poverty analysis based on the results of the current household income an expenditure survey, financed by the Djibouti Urban Poverty Reduction Programme (PREPUD); (iii) sector study on the development of agriculture and fishery. Finally, the Bank's flagship report on regional integration in East Africa, which is being prepared, will also address integration issues relevant for Djibouti.

3.3.1.13 The selected feasibility studies relate to: (i) the transfer of a portion of the water of Lake Afambo (Ethiopia) to Djibouti. The aim is to rationalize regional water resource management and mobilize water for Djibouti. The African Water Facility (AWF) is exploring the possibility of funding the study that could eventually generate a multinational project; and (ii) the Assal Rift geothermal resources, for which the Bank might eventually be requested to provide additional funds, through bilateral trust funds, to supplement those already mobilized from other donors. Geothermal energy will also benefit from RISP initiatives.

3.4 Dialogue Issues

3.4.1.1 The key dialogue issues will focus on:

(iii) **Economic and financial governance:** This dialogue issue will focus mainly on strengthening the capacity of the monitoring and evaluation system, as well as economic management challenges and reforms, particularly within the context of the IMF Extended Credit Facility (ECF).

(iv) **Donor Coordination:** The Bank will actively participate in the establishment of the mechanism under discussion in line with the Paris Declaration (see 2.3.1 and Box 1). This platform will also serve to promote dialogue, especially on co-financing and capacity building.

(v) **Private sector development strategy:** The ESW on private sector profile will support dialogue on the business climate and project financing opportunities. The Bank will also support dialogue on reducing factor costs, including energy, following the entry into operation of the Ethiopia-Djibouti power interconnection network (see 2.2.2.13).

(vi) **Strengthening regional integration:** This issue will focus mainly on investment opportunities that could strengthen regional integration, based essentially on results from the ESW and feasibility studies, in particular in areas of geothermal and water resource mobilization.

(vii) **Portfolio Management:** Discussions will cover issues from the portfolio improvement plan and the outcomes of the Bank review of the public procurement system (see 2.1.2.17).

3.5 Potential Risks and Mitigation Measures

3.5.1.1 **The Endogenous** risks concern: (i) Government commitment to implementing the necessary structural reforms; and (ii) the weakness of national stakeholders' capacity to effectively implement INDS projects and programmes.

3.5.1.2 The first risk is mitigated by the commitment reflected in the renewal of the Government team, which witnessed the appointment of technocrats to positions of responsibility. With regard to the second, there are plans for technical assistance programmes supported by the Bank and other donors, particularly in public finance management.

3.5.1.3 **The Exogenous** risks are: (i) climatic risks; (ii) shocks linked to the prices of imports, especially energy and foodstuffs; (iii) geopolitical instability in the region and its impact on Djibouti's attractiveness; and (iv) external debt sustainability.

3.5.1.4 To cope with the climatic risks, the Government has developed a risk and disaster management strategy, but which still needs to be operationalized. Dialogue with Government and other partners will help to mitigate this risk

3.5.1.5 With regard to food-price related shocks, the authorities of Djibouti have embarked on the acquisition and farming of agricultural land in neighbouring countries, with encouraging results. The goal is to stockpile foodstuffs for sale on the domestic market at subsidized prices.

3.5.1.6 With respect to energy prices, an energy source diversification strategy is underway, including geothermal energy. In addition, the Government plans to explore sustainable conditions for lowering prices after observing the operation of interconnection power line with Ethiopia for about a year. The Bank will keep up the dialogue, in coordination with other partners.

3.5.1.7 The positive trend in FDI flows to Djibouti is evidence that the country is still viewed as a haven of stability in the region. The ongoing reforms aimed at strengthening the supervision of banking activities in an effort to fight against money laundering and terrorist financing, and the presence of the Eurofor anti-piracy force are positive factors.

3.5.1.8 The authorities are conscious of the debt burden and the constraints it exerts on the country's debt strategy. They intend to use grants or concessional loans, particularly within the framework of the programme with the IMF supported by the ECF.

3.6 Monitoring and Evaluation Mechanism

3.6.1.1 This CSP intends to strengthen and use the national system for the monitoring and evaluation of the INDS. The CSP indicators and results framework have been defined accordingly. The CSP results matrix, proposed in Annex I, presents the INDS indicators already available and the expected results, which are relevant for monitoring Bank assistance in Djibouti over the period.

3.6.1.2 However, as noted above, the INDS monitoring and evaluation system is hampered by major weaknesses which render it ineffective. In this respect, the priority goal of the Bank support to the monitoring and evaluation system, starting in 2011, will be to ensure that INDS benchmark indicators are available during the CSP mid-term review scheduled for 2013.

3.6.1.3 With the exception of the support to the monitoring and evaluation system and a number of non-project activities, it should also be noted that other Bank interventions, which will actually start in 2012, are not likely to produce any tangible results by the time of the CSP mid-term review. The mid-term review will therefore provide an opportunity to evaluate the results of the water and sanitation project in the city of Djibouti, adjust and enhance the matrix of measurable results to be achieved in 2015.

3.6.1.4 By 2015, the monitoring and evaluation system should therefore be able to produce at least the outcome indicators on a regular basis and the INDS progress report.

4. CONCLUSION AND RECOMMANDATIONS

3.6.1.5. The Government's development strategy, aimed at making Djibouti a regional hub for trade and services, has produced results in terms of economic growth. It has, however, shown some limitations, particularly evident in the persistence of the people's poor living conditions, as well as the high unemployment levels and the incidence of poverty.

3.6.1.6 The persistent fragility of Djibouti, as reflected in the weakness of its institutional capacity, accounts for much of the poor performance of social indicators. This situation could undermine the sustainability of the country's growth and development model.

3.6.1.7 In this regard, this 2011-2015 CSP seeks to support the Government's efforts to address the challenges and constraints hindering inclusive growth, thus paving the way for improved living conditions, economic diversification and job creation, in an effort to subdue poverty, which remains endemic in the country.

3.6.1.8 This 2011-2015 CSP is articulated around a single pillar: **Strengthening socio-economic infrastructure.** This pillar is consistent with the INDS 2011-2015 for Djibouti and with the Bank Group's Medium-Term Strategy.

3.6.1.9 The Boards of Directors are requested to consider and approve:

(i) The Country Strategy Paper (CSP) 2011-2015 for Djibouti; and,

(ii) Djibouti's eligibility for the resources of Pillar 3 of the Fragile States Facility, amounting to UA 2.5 million.

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ANNEX I

TABLE OF EXPECTED OUTCOMES

Major development goals defined in the INDS	Problems hindering achievement of desired output/sector issues	Indicators of final outputs (expected by 2015)	Final inputs of Bank interventions (2015)	Output indicators at mid-term (by 2013)	Key measures and output indicators at mid-term (by 2013)	Bank Group interventions (current and planned for the CSP period
Single Pillar: Promotion of Socioeconomic Infrastructure						
Expanding access to water and sanitation	Water scarcity Limited access to drinking water and sanitation Annual water production below demand High production cost due to energy costs Obsolete and limited sanitation network	Increase in the proportion of households with access to drinking water supply from 40% in 2010 to 50% in 2015 Increase in the proportion of households connected to the sanitation network from 25% in 2010 to 35% in 2015	Increased number of households with access to drinking water supply Increased number of households connected to the sanitation network Rehabilitation of the sanitation network Construction of a sewage treatment plant	The proportion of households with access to drinking water supply stands at 46% in 2013 The proportion of households connected to sanitation network is 31% in 2013	Connection of X households to the drinking water network Connection of X households to the sanitation network	<u>Ongoing</u> Djibouti City sanitation project Study on the mobilization of surface water <u>Planned</u> Construction of a seawater desalination plant (to be confirmed) Infrastructure to improve access to water and sanitation in rural and semi-urban areas (2012)
Primary sector development	Arid climate and limited water resources Low levels of farmland development Under-exploitation of fishery resources Domestic production of only 10% of the country's food	Decline in proportion of population with food insecurity from 21% in 2010 to 10% in 2015 Increase in proportion of urban population able to afford a minimum diet, which stood at 51% in 2010 Increase the primary sector's contribution to	Increased local agricultural production Increased off-shore agricultural production Development of fisheries production Increased livestock	The proportion of population with food insecurity stands at 14% in 2013 The proportion of urban population able to afford the minimum diet is at least 66% in 2013 Primary sector's contribution to GDP is X%	Local agricultural production reaches X tonnes per crop type Off-shore agricultural production reaches X tonnes per crop type Fish production reaches X tonnes reaching	<u>Ongoing</u> Study on the mobilization of surface water<u>Planned</u> Sector work on the development of the agricultural and fishery sectors (2012/2013) Infrastructure project intended to optimize the country water resources for multiple use (domestic,

	needs	GDP from 4% of GDP in 2010 to X% in 2015		in 2013		agricultural and pastoral) (2012/2013) Integrated project for support to primary industry aimed at participating in various stages of the production chain in the agricultural, fisheries, livestock and agro-industry sectors (2014, to be confirmed) Study on the feasibility of transferring water from Lake Afambo
Decline in poverty and unemployment	Low levels of development of labour-intensive sectors: agriculture, industry, and the like. Low levels of economic diversification Low level reinjection of resources from the banking system into credit for SMEs/SMIs	Decline in unemployment rate for the poorest 20%, which stood at 63% in 2010 Decline in the poor unemployment rate from 74% in 2010 to 50% in 2015 Decline in the incidence of extreme poverty to 30% in 2015 (the last available figure was 40% in 2002)	Promotion of the establishment of SMEs/SMIs through the development of market and employment-generating infrastructure Improvement of access to credit for SMEs/SMIs through a guarantee fund that provides collateral	Unemployment rate of the poorest 20% reduced by 50% in 2013 Unemployment rate of the poor is 60% in 2013 The incidence of extreme poverty is 35% in 2013	Creation of X jobs	<u>Ongoing</u> Education Project III Poverty reduction project <u>Planned</u> SME/SMI Guarantee Fund (to be confirmed) Market infrastructure development project (2014, to be confirmed) Profile study on the private sector and growth sources (2012)

Strengthening the effectiveness of the State.	Disconnect between spending by sector ministries and the INDS strategic priorities Lack of planning and programming instruments Major failures in national statistics system Absence of an appropriate system for monitoring and evaluating the INDS and projects implemented	Improvement of the country's PEFA score Availability of INDS progress report INDS monitoring indicators are produced regularly	Establishment of an effective monitoring and evaluation system The officers in charge of producing statistics were trained The staff of central and sectoral planning units were trained in results-based management and monitoring and evaluation The main planning and programming instruments for the fiscal year are available	All baseline data on INDS monitoring indicators are defined and available Number of ministries that have set up a planning and programming unit Number of officers trained in statistics Number of officers trained in monitoring and evaluation and results-based management Number of available planning instruments and statistics	100% of baseline data of INDS indicators are available At least four key ministries have set up planning units X officers received training in statistics X officers received training in monitoring and evaluation and results-based management At least completed processing of the census and household income survey data	Planned Project to strengthen public finance management and monitoring and evaluation (2011)

ANNEX II

INDICATIVE PROGRAMMES FOR 2011-2015

- **Indicative Lending Programme and Reserve Pipeline of Projects for 2011-2015**

Country	Period	Sector Department	Sector	Instrument	Project Description
Djibouti	2011	OSFU/OSGE	Multi-sector (Planning and monitoring-evaluation)	FSF (Pillar 3)	Strengthening of the Government's institutional capacity
Djibouti	2012	OWAS	Water and Sanitation	ADF-12 RWSSI	Infrastructure to improve access to water and sanitation in rural and semi-urban areas
Djibouti	2012/2013	OWAS	Water	ADF-12	Development of water resources for multiple use (domestic, agricultural and pastoral)
Djibouti	2014/2015	OSAN	Agricultural infrastructures	ADF-13	Promotion of the value chain in the primary sector
Djibouti	2014/2015	OSHD	Social infrastructures	ADF-13	Market infrastructure and employment-generating activities

- **Indicative Lending Programme and Reserve Pipeline of Projects (Private sector and multinational)**

Country	Period	Sector Department	Sector	Instrument	Project Description
Djibouti	2012-2015	OPSM	Finance	ADB (Private sector)	Promotion of SMEs/SMIs
Djibouti	2012-2015	OPSM	Infrastructure	ADB (Private sector)	Infrastructure project targeting the reduction of factor costs and access to drinking water
Multi-national	2012-2015	OSAN	Infrastructure	ADF-12 or ADF-13	Mobilization and rational management of regional water resources

- **Indicative Programme of Economic and Sector Work**

Country	Period	Sector Department	Sector	Instrument	Project Description
Djibouti	2012	OREB	Private sector	ESW	Private sector profile, including identification of the potential sources of growth and promotion of entrepreneurship
Djibouti	2012-2013	OSAN	Primary sector	EES	Sector study on the development of agriculture and fishery
Djibouti	2013	OREB/EDRE	Poverty analysis	ESWS	Poverty profile based on the results of the household income and expenditure survey

- **Indicative Programme of Feasibility Studies**

Country	Period	Sector Department	Sector	Instrument	Project Description
Djibouti	2011-2012	ONEC	Energy	Study (Trust Fund)	Geothermal resources of the Assal Rift for electricity production
Multinational	2011-2012	AWF/OSAN	Water/ Agriculture	Study (Trust Fund)	Feasibility study on the transfer of water from Lake Afambo (Ethiopia) to Djibouti

ANNEX III

DUBAI EMIRATE'S DFI IN DJIBOUTI

Foreign Direct Investment (FDI) in Djibouti from the Dubai Emirate

Djibouti's economy has since 2000 recorded a massive influx of FDI mainly from Gulf countries, especially the Dubai Emirate. The Emirate's direct investments through Dubai World investment company include: the expansion of the historic port of Djibouti, the construction of Doraleh container terminal, an oil terminal, a luxury hotel and upscale estates built by Nakheel, the real estate arm of Dubai World. In addition, DP World, Dubai World's port operator, manages Djibouti's seaport and airport. Dubai's Jebel Ali Free Trade Zone Authority manages the free trade zone in Djibouti.

These investments are part of the Government's strategy to make Djibouti a hub for trade and services in the region. They have increased the port's capacity for both incoming traffic, mainly to Ethiopia, and transhipment traffic - the terminal's capacity has been raised to 1.5 million twenty-foot equivalent units - thereby increasing the efficiency of port services and lowering transportation costs. These operations have also encouraged other private investments in the services sector, such as the provision of supplies to foreign military vessels and the installation of a quarantine unit for re-exporting cattle, mainly to the Gulf.

Dubai World's problems have caused the investor to revise its investment and expansion plans in the country, postponing but not cancelling them. So far, the crisis Dubai World is facing and the debt restructuring plan do not seem to have had any adverse impact on the operations of DP World and Nakheel.

ANNEX IV

CONSULTATIONS WITH STAKEHOLDERS

Consultations with Stakeholders

A consultation workshop with stakeholders was held in May 2011. It was attended by more than 15 groups representing the public and private sectors, civil society and donors. The participants welcomed this joint initiative of the Government and the Bank, which enhances understanding of Bank's areas of intervention and its positive impact on Djibouti's development, which are not always known to the general public.

At the end of the discussions, consensus was reached on: (i) the country's challenges and opportunities as presented in the CSP; (ii) the assistance strategy proposed by the Bank Group, focusing on water and sanitation infrastructure, and agricultural and market infrastructure; (iii) the need to promote private sector development, especially by improving the business climate and supporting SMEs/SMIs; (iv) topics for economic studies focusing on the private sector, regional integration and tapping of Djibouti's potential.

Participants were unanimous in acknowledging the generally low capacity of not only the public sector but also private sector actors. They called for a substantial drop in input costs, especially electricity and water, and the extension of access to as many people as possible. It was underscored that energy constraints severely limit development prospects. The non-implementation of activities relating to the Ethiopia-Djibouti Power Interconnection at the time of the workshop made it difficult to capture the impact of this major contribution on the country.

. Individual entrepreneurship needs to be promoted in areas as diverse as construction, trade, agriculture and fishing, in an effort to diversify the economy and expand employment opportunities for the working population.

ANNEX V

ECONOMIC AND FINANCIAL INDICATORS 2008-2015

Table 1. Djibouti: Selected Economic and Financial Indicators, 2008–11

(Quota: SDR 15.9 million)
(Population: 0.818 million; 2009)
(Per-capita nominal GDP: $1,282; 2009)
(Poverty rate: 42 percent; 2002)

	2008 Act.	2009 Act.	2010 Prel. Act.	2011 Proj.
	(Annual percent change, unless otherwise indicated)			
National accounts				
Real GDP (annual change in percent)	5.8	5.0	3.5	4.8
Consumer prices (annual average)	12.0	1.7	4.0	8.5
Consumer prices (end of period)	9.2	2.2	2.8	9.0
	(In percent of GDP)			
Investment and saving				
Total fixed capital investment	46.7	35.5	20.8	26.1
Private	32.9	18.3	9.0	14.5
Public	13.8	17.2	11.7	11.6
Gross national savings	22.4	26.4	16.0	15.8
Savings/investment balance	-24.3	-9.1	-4.8	-10.4
Public finances				
Total revenue and grants	41.9	37.0	35.4	35.6
Of which: Tax revenue	20.0	20.1	20.2	20.2
Expenditure and net lending 1/	40.6	41.6	36.0	35.3
Of which: Current expenditure	26.8	24.3	24.3	23.6
Capital expenditure	13.8	17.2	11.7	11.6
Overall balance (commitment basis, incl. grants) 1/	1.3	-4.6	-0.6	0.4
Domestic financing	-0.6	-0.2	0.1	-1.2
External financing	2.6	5.9	1.3	2.0
Change in domestic arrears (decrease -) 2/	-3.2	-1.2	-0.8	-1.2
	(Annual change in percent, unless otherwise			
Monetary sector				
Net foreign assets	23.1	12.1	5.1	5.2
Net domestic assets	10.0	43.1	38.6	14.5
Claims on the private sector	27.3	26.6	21.4	12.5
Broad money	20.6	17.5	12.2	7.7
Velocity of broad money (ratio)	1.2	1.1	1.1	1.1
Average commercial lending interest rate (in percent)	11.4	11.7	…	…
	(In millions of U.S. dollars, unless otherwise			
External sector				
Exports of goods and services	369	399	359	472
Imports of goods and services	-704	-578	-497	-679
Current account balance (in percent of GDP) 3/	-24.3	-9.1	-4.8	-10.4
FDI in percent of GDP	23.8	9.5	2.4	7.2
Stock of external public and publicly guaranteed debt (in percent of GDP)	60.2	60.0	56.1	53.0
Gross official reserves 4/	173.7	217.5	230.6	242.1
(in months of next year's imports of goods and services)	3.6	5.2	4.1	3.2
Memorandum items:				
Nominal GDP (in millions of Djibouti francs)	174,617	186,447	200,578	228,098
Currency board cover (in percent) 5/	120.9	135.4	122.4	115.6
Exchange rate (DF/US$) end-of-period	177.7	177.7	177.7	…
Real effective exchange rate (yearly average, 2005=100)	87.8	94.9	98.5	…
(Change in percent; depreciation -)	-23.4	8.0	3.8	…

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

1/ In 2009 includes externally financed projects of public enterprises guaranteed by the government amounting to 3.7

2/ Does not include repayment of arrears to public enterprises accumulated in 2009. Repayment of these arrears is included in current expenditure in 2010-12 .

3/ Revised based on new estimates of outgoing remittances.

4/ In 2009, includes special and general allocation of SDR 14 million.

5/ Gross foreign assets of the CBD in percent of monetary liabilities

ANNEX VI

SUMMARY TABLES ON STATUS OF MDGs (as at 30 September 2010)

Goals	Targets	Indicators Selected	1990	2000	2002	Current Status of Indicators	MDGs 2015	Rating
1. Eradicate extreme poverty and hunger	Halve, by 2015, the proportion of people living on less than $1.8 a day	Proportion of the population living below the poverty line Prevalence of underweight children under five years of age		 25.7%	42.1% 23.8%	 28.6%(2006)	21.0% 15.0%	
	Significantly reduce unemployment, particularly for women and young people	Proportion of unemployed persons among the active population			59.5%			
2. Achieve universal primary education	By 2015, all children can complete a full course of primary schooling, girls and boy	Enrolment rate: Primary Secondary (middle school) Net enrolment ratio in primary education		 39.0% 19% 27,0%	 52.3% 23% 43.2%	 74.3%(2009) 50.0%(2009) 66,2%	 100.0% 77.0% (nati.nal) 100.0%	
		Primary education enrolment rate Rate of completion of the 5th year of primary education		36%	46%	83.4%(2009) 78.8%(2009)	100.0% 98.0%	
		Literacy rate			46.2%		95.0%	
3. Promote gender equality and empower women	Achieve 1 to 1 ratios of girls to boys in primary, secondary and higher education by 2015	Ratios of girls to boys in primary, secondary and higher education	0.73 0.66 -	0.73 0.6 -	0.9 0.7 -	0.98 (2006) 0.72 (2009) 0.69 (2009)	1 1 1	
	Increase the literacy rate for women	Female literacy for 24-25 year-olds			14.8%	47.5% (2006)	100.0%	
	Increase women's participation in economic life	Proportion of women in: - Formal private sector - Public service				 14.6% (2008) 24.4% (2008)		

Goals	Targets	Indicators Selected	1990	2000	2002	Current Status of Indicators	MDGs 2015	Rating
	Augmenter la participation Increase women's participation in public life	Proportion of women in: . Government . National Assembly . Regional and Communal Councils	0.0%	5.0% 0.0%	10.0% 10.7%	9.5% (2010) 14% (2010) 11% (2010)	30.0% (national)	
4. Reduce the under-five mortality rate	Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate	Infant (under 1) mortality rate	106.4‰		99.8‰	67.0‰ (2006)	35.30‰	
		Under-five mortality rate	131.1‰		127.0‰	94.0‰ (2006)	43.70‰	
		Proportion of 1-year-old children immunized against DTC3 Polio			53.1%	83.1% (2008)	100.0% (national)	
5. Improve maternal health	Reduce by three quarters, between 1990 and 2015, the maternal mortality ratio Achieve, by 2015, universal access to reproductive health	Maternal mortality per 100,000 live births		740	546	118 (2009)	185	
		Proportion of births attended by skilled health personnel		56%	72.8%	87.4% (2006)	100.0%	
		Contraceptive prevalence rate for women aged 15-49			15.3%	33.5% (2009)		
		FGM prevalence rate (women aged 15-49)				93.1% (2006)		
6. Combat HIV/AIDS, malaria, tuberculosis and other diseases	Have halted by 2015 and begun to reverse the spread of HIV/AIDS Achieve, by 2010, universal access to treatment for HIV/AIDS for all those who need it Have halted by 2015 and begun to reverse the incidence of malaria and other major diseases	HIV/AIDS prevalence rate	0.2%	3.1%	3%	2.1% (2009)	1.8% (national)	
		Tuberculosis prevalence rate (100,000 inhabitants)	619	700		1161 (2009)	400 (national)	
		Malaria prevalence rate				115‰ (2009)		
		Death rates associated with malaria			5%			
7. Ensure Environmental Sustainability	Halve, by 2015, the proportion of the population without	Proportion of population with access to an improved water source	76.0%	88.0%	91.2%	93.5% (2006)	100.0%	

Goals	Targets	Indicators Selected	1990	2000	2002	Current Status of Indicators	MDGs 2015	Rating
	sustainable access to safe drinking water							
	By 2020, to have achieved a significant improvement in the lives of at least 100 million slum-dwellers	Proportion of population with title deeds				30% (2004)		
		Proportion of population with access to improved sanitation				67%(2006)	100.0% (national)	
Macroeconomic Indicators		GDP in constant prices (DJF million)		98,267	105,128	186,969 (2009)	270,759 (2013)	
		Growth rate (in % of real GDP)		0.7%	2.6%	5.0% (2009)	6.5%	
		Debt services in % of goods and services exports		6.0%	7.2%			
		External debt in % of GDP		65.0%	66.8%			
		Inflation rate (in %)		2.4%	0.6%	2.2% (2009)		
		Investment (% of GDP)		20.8%	10.2%			

Source: Government of Djibouti, 2010

Key:

- Likely
- Unlikely
- Data not available

ANNEX VII

DEBT SUSTAINABILITY ANALYSIS

This annex summarizes the main conclusions of the joint debt analysis carried out by the International Monetary Fund and the World Bank in 2010.

Djibouti continues to face a high risk of debt distress. This observation is based on the external evaluation of the joint World Bank/IMF debt sustainability analysis (DSA), and was confirmed by the conclusions of the public sector debt sustainability analysis. The present value of the debt-to-GDP ratio and the debt-to-exports ratio exceeds the respective indicative thresholds recommended in the baseline scenario. However, medium-term concessional financing and high exports may help to contain debt service ratios. Given the limited debt relief options, Government policy priorities are geared towards increasing the competitiveness and quality of public investment management. Improvements in these areas are aimed at pushing growth dividends up to levels that would help to reduce Djibouti's debt burden.

1. Context and Assumptions

- **Djibouti's external public debt remains high**. The total external debt, including public debt and public guaranteed debt, was estimated at USD 626 million at end-2009 or 60% of GDP. Sixty-six per cent of the external debt is held by multilateral creditors, 12% of the remaining 34% is held by Paris Club creditors, and the remainder is shared between Kuwait and Saudi Arabia.

The stock of domestic public debt is low with 14% of GDP at end-2009, 9% of which are domestic arrears owed to civil servants and suppliers, the remainder being outstanding loans owed to commercial banks and the Port.

- **The country's external debt is high compared to that of other low-income countries**. Djibouti's debt was restructured under the Houston terms in 2008. However, since most of the debt is multilateral, the portion covered by the agreement remains low. As a result, Djibouti is one of the low-income countries with the highest external public debt and debt guarantees, compared to both HIPC countries that have reached completion point and non-HIPC low-income countries.

- **The borrowing strategy is the basis for higher future growth for the country**. Djibouti experienced a rapid transformation financed by foreign direct investment mainly from Arab countries and public investment in human and physical capital as part of a long-term growth strategy aimed at transforming the country into a regional hub for port, logistics and financial services.

- **The medium-term baseline scenario has deteriorated compared to the previous debt sustainability analysis (DSA)**. Growth for the 2010-12 period was revised downward to 5% from an annual average of 7%, as a result of reduced export opportunities due mainly to cancellation of the construction of a refinery, as well as the dampening effect of the global financial crisis and the Dubai debt moratorium.

- **Although the risk rating remains the same, the outlook has deteriorated compared to the debt sustainability analysis (DSA).** It is estimated that, for a country like Djibouti, the present value of the debt-to-GDP ratio will reach the sustainable level of 30% only in 2025, whereas the previous analysis was projecting 2016. The difference is due to a decline in estimated growth rates for the period.

2. External debt and debt sustainability analysis

- **Djibouti remains at a high risk of over-indebtedness.** Stress tests show that the debt burden indicators (debt compared to GDP, exports and revenue earnings) are highly vulnerable to a combination of shocks, while the debt service indicators (debt service compared to export and revenue) are most vulnerable to an exports shock and a one-time currency devaluation (however, this scenario is unlikely given that Djibouti operates under a currency board arrangement whereby its currency is pegged to the dollar).

- **Stress tests indicate that the external debt sustainability is more vulnerable to a combination of shocks**. The most extreme shock is a combination of shocks that assumes that real GDP growth, the growth in exports value, the dollar deflator and the flows, by not creating any debt, stand at their reduced historical levels of half a standard deviation.

- **The debt burden indicators are the most vulnerable**. The NPV-to-GDP reaches its indicative threshold in all stress tests. The vulnerabilities are prolonged, and the indicator remains above its threshold until 2025. The situation is the result of a prolonged disconnect from the baseline scenario. The second most vulnerable debt indicator is the debt-to-exports ratio, which exceeds its threshold in seven of eight stress tests. Vulnerability persists until 2015 in most of the tests. The most resilient debt indicator is the debt-to-revenue ratio, which exceeds the indicative thresholds in only three tests.

- **The least vulnerable are the debt service indicators**. Given the high and stable influx of foreign currency into Djibouti for port services and payments for the military bases, and the high level of concessional financing, the debt service indicators remain below their indicative thresholds throughout the projection period. As expected, the biggest vulnerability is a shock from exports and a one-time currency devaluation.

Djibouti: External Public Debt Indicators

	Thresholds	End-2010	2010-2015	2016-2030
Present value in % of:				
- GDP	30	53.7	47.4	32.4
- Exports	100	147.6	120.4	56.6
- Revenue	200	179.8	156.7	98.8
Debt service in % of:				
- Exports	15	9.2	8.7	4.8
- Revenue	25	11.2	11.4	8.4

3. Public debt sustainability analysis

- **The results of public debt sustainability analysis are similar to those of the DSA for the external debt.** In the baseline scenario, it is estimated that public debt indicators will improve in the medium-term. The present value of the debt-to-GDB ratio falls from 67% in 2010 to 30% in 2030. The present value of the debt-to-revenue ratio also drops from 90% to 87% in 2030, reflecting the relatively high and stable Government revenue.

- **Stress tests suggest that Djibouti is vulnerable to a decline in growth.** A 1.8% decline in growth, equivalent to the historical average minus one standard deviation, increases the debt for the entire projection period well beyond the baseline to 61% in 2030, as against 30% in the baseline scenario. As with the external debt indicators, debt servicing does not show any significant vulnerabilities, and reduced growth increases debt servicing by 5%, compared to the baseline scenario.

- **Public sector vulnerabilities underscore the importance of public investment management in the country.** Efforts to improve the investment process by identifying, selecting and successfully implementing appropriate and productive projects can be instrumental in promoting investments that are likely to restore growth and, by the same token, improve debt sustainability.

4. Authorities' views

- **The authorities agree with the overall assessment**. They have acknowledged that the relatively high debt levels call for fiscal prudence and strengthening of debt management through the development of a medium-term debt strategy. They have also emphasized the importance of public investment management in Djibouti, including the prioritization of some of the numerous projects and the choice of projects with high returns on investment. Conscious of the threat which non-concessional loans pose to debt sustainability, the authorities will endeavour to secure additional concessional funding, especially through a donors' round table.

5. Conclusions

- Djibouti has a high risk of debt distress. The debt relief options for reducing its debt levels are limited. Although the country's debt was rescheduled by the Paris Club creditors, the debt levels are still high. The external debt bilateral components covered by this agreement were relatively low. Moreover, the country could not be granted debt relief, given that it was not eligible for the HIPC Initiative and the Multilateral Debt Relief Initiative (MDRI).

ANNEX VIII

LIST OF ONGOING PROJECTS IN THE COUNTRY

Active Project Portfolio in the Country at end June 2011

Sector	Project Title	Source of Finance	Approval Date	Approved Amount in million
OSHD	EDUCATION PROJECT III	ADF	14-Jul-04	UA 4.63
OSHD	EDUCATION PROJECT III	ADF	14-Jul-04	UA 0.37
OSHD	POVERY REDUCTION PROJECT	ADF	17-Oct-08	UA 5.82
OWAS	DJIBOUTI CITY SANITATION PROJECT	ADF	18-Dec-07	UA 6.5
AWF	SURFACE WATER MOBILIZATION	EAF	29-Jan-08	UA 1.65
ONEC	ETHIOPIA-DJIBOUTI INTERCONNECTION - DJIBOUTI	ADF	13-Dec-04	UA 17.6
ONEC	ETHIOPIA-DJIBOUTI INTERCONNECTION – DJIBOUTI SUPPL. LOAN	ADF	8-Oct-08	UA 15.72
OPSM	DORALEH CONTAINER TERMINAL	ADB	24-Sept-08	UA 52.0
OPSM	DJIBOUTI BULK CARRIER TERMINAL PROJECT	ADB	3-Dec-03	UA 6.55
ALSF	AFRICAN LEGAL SUPPORT FACILITY	ALSF	29-May-10	USD 0.5

ANNEX IX

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