Mid year gauge **Democratic Republic of the Congo (DRC)** June 2008

Political landscape remains fragile

Since the signing of the historic peace deal in January 2008, the country has experienced some easing of tensions and conflicts, especially in the Nord Kivu regions. However, it is still too early to celebrate as the ground on which the new and fragile government stands is yet to be tested. The arrest of Jean-Pierre Bemba (who came second in the 2006 presidential election) brings another dimension to the evolving peace process. Following heavy fighting in Kinshasa between the presidential guard and forces belonging to Mr. Bemba, he fled to Portugal. His long absence from Cabinet meant that he lost the immunity from prosecution accorded to senators. It was possible for the International Criminal Court (ICC) to execute a warrant of arrest for his alleged involvement in four counts of war crimes and two counts of crimes against humanity committed between October 2002 and March 2003 in the neighbouring Central African Republic. It remains a challenge for the government to foster peace among Mr. Bemba's followers who feel that parliament (let alone government) is not doing enough to secure his release, especially as he is the leader of the official opposition. Even though the government enjoys some general legitimacy and vote of confidence, the failure of the fragile peace process might cause some discontentment that could offer other opposition parties solid grounds to strengthen their strongholds, especially building towards the 2011 general elections. Thus far, government enjoys a relatively stable administration that continues to exercise its democratic mandate cautiously.

The government continues to commit itself to the reconstruction programmes aimed at rebuilding this mineral-rich African state. It continues to uphold prudent macroeconomic policies that are fostering more fiscal and monetary discipline. Consumer inflation has remained in the single digits since January 2008, while the exchange rate has remained relatively stable. However, the country still faces major challenges in both an economic and social context. Despite the abundance of mineral resources, the country remains one of the poorest nations in the world with about 80% of the population living on less that US$1 a day. The poverty rate is estimated at about 70% of the population and inequalities continue to widen. Skills shortages compounded by a poor education system pose serious challenges going forward. Lack of schooling for many years due to war has resulted in a very low employment rate, estimated at 63.1%. Rebuilding the school system remains a major challenge due to dilapidated or non-existent infrastructure. Poor teachers' compensation resulted in a late start to the 2007/08 school year. In an attempt to address the shortfalls in the education system, in line with the Millennium Development Goals (MDG), government has committed to building and renovating a lot of primary and secondary schools. The budget allocation to education has been increased from 3% to 12%.

The national health system also needs a major overhaul as it still falls short of World Health Organization (WHO) standards. The Organization for Economic Cooperation and Development (OECD) estimates that only 26% of the population live within 5km of health facilities. The OECD continues to report that there is one health centre per 10 218 inhabitants (the standard is one per 10 000 inhabitants) and one major hospital per 180 397 inhabitants (against a standard of one per 150 000 inhabitants). For a country as large as DRC, these statistics probably underestimate the severity of the challenges that exist. The Human Development Index (HDI), which measures a country's achievements in longevity, knowledge and decent standard of living, ranked DRC 168 out of 177 countries.

Overall, peace and stability alone might not guarantee success and prosperity due to the major challenges that lie ahead. Government's commitment to physical and social infrastructure development, prudent macroeconomic policies and strengthening of institutional framework and administrative capability, among others, should help to anchor the reconstruction path the country has adopted.

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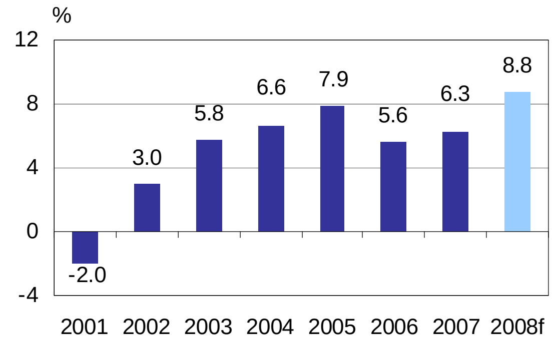
Economic structure and development

The country's policy direction remains favourable for growth in the medium term. Having grown at 6.3% in 2007 (against the Congolese authorities' target of 6.5%), the economy is expected to record positive real growth of over 8% in 2008. The strong economic growth envisaged from the second half of 2007 should continue through 2008/09. The stabilisation of the fiscal space and improved administration of the fiscus should lead to a better allocation of public resources. Large donor inflows should continue in the medium term, and any steps the government takes to move closer to the International Monetary Fund's (IMF) poverty reduction and growth facility (PRGF) programme should lead to additional aid commitments from international donor agencies. The improved security environment should not only lead to a reduction in government expenditure but also increased investor confidence, which should facilitate more investment in this resource-rich country. This should lead to increased trading activity both within and outside the region.

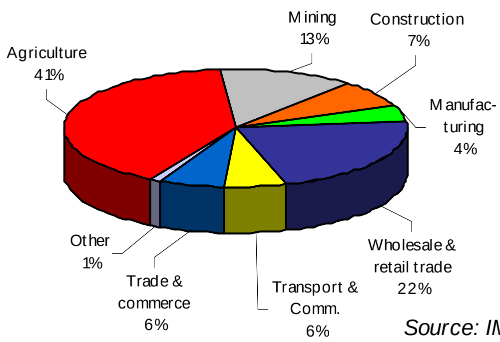
Real GDP growth (%)



Source: IMF

Thus far, government's commitment to a stable macroeconomic environment has yielded positive results. Inflation has declined to single digits. There has been an arrest in the fiscal slippage experienced during 2006/07 period. The Congolese franc exchange rate has been relatively stable. Various sectors of the economy should benefit from the stable macroeconomic environment and government's commitment to rebuilding the economy. The agriculture sector continues to employ about 60% of the population while contributing about 41% of GDP. However, the sector still performs below its capacity. Despite massive potential for large-scale commercial farming, the sector is still dominated by small-scale farmers, and a lack of access to finance (especially from banks) remains a major constraint. For the agriculture sector to reach its full potential, requires massive infrastructural investment to support any reconstruction efforts currently underway. In the medium term, we expect the agriculture sector's output to increase on the back of infrastructure investment, especially in the transport network. Improvement in transport infrastructure should also ease distribution bottlenecks and facilitate transportation of agricultural products to other parts of the country thereby reducing food price pressures.

Contribution to GDP (%)



Source: IMF

The mining sector, which constitutes about 13% of GDP, is the main driver of growth. Despite the country's vast natural resources, the mining sector has not realised its full potential. However, the positive political and economic developments continue to support more investments in this sector. The government is committed to addressing poor management and lack of public and private investment in the sector. Thus far, the improving political environment is attracting more foreign investment in the mining sector. Asset-backed deals signed between the Congolese authorities and China (about US$9.3 billion) for infrastructure development and mining are of significance. The commodity boom continues to propel the mining sector's performance. By mid 2007, total diamond production had increased by 7.5%. Copper, cobalt and zinc production had increased by 2.5%, 3.5% and 8.1% respectively. The new mining code and successful renegotiation of mining contracts should support further growth in the sector thereby generating more state revenue that can be ploughed back into infrastructure development.

The construction sector, which constitutes about 7% of GDP and growing at about 5% per annum, should continue to benefit from current infrastructure development. However, massive constraints still exist in sourcing inputs, such as cement, to carry construction projects forward more rapidly. We expect more donor assistance to be directed towards construction projects, which should help to yield high growth in the sector. We do not expect robust growth in the manufacturing sector due to high concentration in the capital, Kinshasa. Political stability in the capital should continue to dictate developments in this sector. However, effective diversification to other urban areas should help to address this shortfall. The transport and communication sector, which constitutes about 6% of GDP, has been another source of growth. This was mainly due to a significant increase in the communications sector where demand for mobile phones reached five million in 2007.

Overall, medium-term growth prospects look positive though heavily reliant on donor support for infrastructure development. Improved performance in the mining, construction, agriculture and telecommunication sectors should facilitate stronger growth in the medium term. The recent deal that has so far led to a reduction in unrest and conflicts in the Nord Kivu region continues to offer hope for further political stability. Coupled with the revised mining and investment codes, this should make the country more attractive to foreign investors.

High global commodity prices should further increase export revenue that should offer more budget support even though the country will continue to rely heavily on international donor aid. The emphasis on increased investment by regional communities (for example, Southern African Development Community – SADC) in infrastructure, such as transport and power, should also benefit the country.

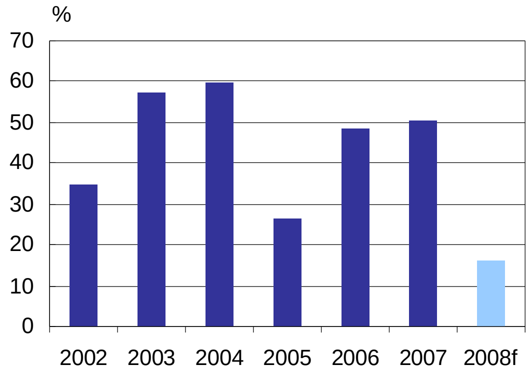
Monetary policy

We expect the DRC's central bank (Banque centrale du Congo - BCC), to continue implementing tight monetary policy through 2008. Tight monetary policy is seen as essential for government to secure the IMF's assistance in terms of the PRGF programme. The government's failure to meet its monetary and fiscal targets led to the suspension of the PRGF programme in March 2006. The restoration of the programme should see more international donor agencies committing funds to the country.

Even with limited ability to control liquidity through other monetary policy instruments, such as interest rates or government bills, the BCC continues to control base money growth in an attempt to curb inflationary pressures from large inflows of foreign funds. The country has so far attracted well over US$10 billion in foreign investments directed at infrastructure development and mining. During 2008, we expect international reserves to reach about US$260 billion, equivalent to seven months of import cover. Money supply is forecast to increase by about 16.3% in 2008 compared with 50.1% in 2007.

The BCC continues to face mounting challenges in implementing monetary policy. There is a need to manage the excess liquidity generated by the large inflows of foreign aid and revenue from commodity exports while controlling the impact of sterilisation on interest and exchange rates. The effectiveness of the BCC is also hampered by the state of the country's financial markets and the banking sector. Financial markets are still shallow while the banking sector is highly dollarised. While the ratio of broad money to GDP has more than doubled from 5% in 2001 to 12.3% in 2007 (forecast to be about 12.1% in 2008), it is still less than half that of the sub-Saharan Africa (SSA). Any resumption in conflicts might lead to increased fiscal outlays that could result in monetary expansion thereby exerting more pressure on inflation and exchange rates.

Money supply



Source: IMF

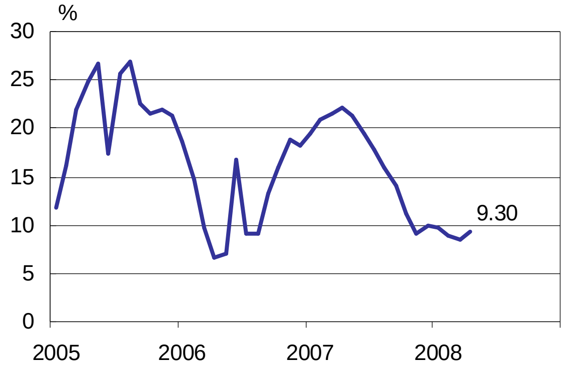
Inflation

We expect inflation to remain relatively subdued through 2008 due to improvements in agricultural production and an improved security landscape that should help to facilitate the distribution of consumer items from one part of the country to the other. The continued elevation of global food prices has led government to uphold special taxes and reduction in tariffs on basic food products such as maize, rice, meat, poultry, flour and sugar. Continued inflows of financial support have helped to strengthen the currency, thereby leading to subdued imported inflation. The inflows should help the monetary authorities to keep tight control on money supply, as revenue constraints would be eased. Thus, continued fiscal discipline and tight monetary policy should also facilitate a lower inflationary environment in the medium term.

Inflation, as measured by prices in the capital, Kinshasa, averaged 9% in the first quarter of 2008 compared with an average of 10.1% in the last quarter of 2007. Inflation averaged 9.1% in the year to April 2008 compared with 21.1% in the same period during 2007. The last recorded inflation for April ‘08 was 9.3% y/y.

The BCC still faces major threats to the inflation outlook. The country’s dilapidated infrastructure continues to impose significant transport costs that are adding to inflationary pressures. The government’s commitment to revitalising and rebuilding infrastructure should lead to increased government spending, which might pose significant challenges in containing prices. High global food and energy prices should exert significant inflationary pressures going forward. We are forecasting inflation to average 14.1% in 2008.

Consumer inflation – % y/y

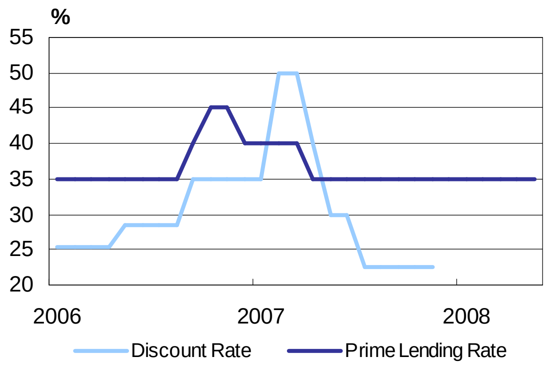


Source: IMF

Interest rates

Interest rates remained relatively stable due to a subdued inflation environment. However, we expect the authorities to maintain tight monetary and prudent fiscal policies. Increased government spending on infrastructure and security might pose threats to the inflation environment. Coupled with continued high global energy and food prices, this might prompt the BCC to tighten monetary policy further. However, we expect the discount rate to remain at its current levels in the medium term. Continued development of the financial system should support the effectiveness of monetary policy.

Interest rates

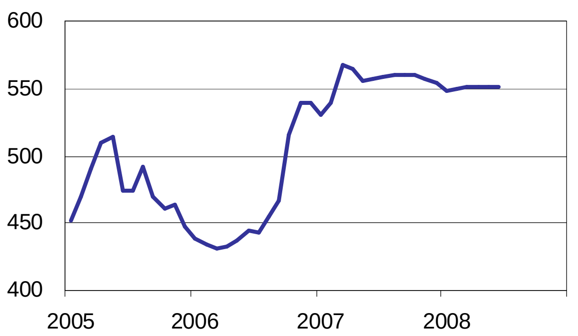


Source: IMF, Banque Centrale du Congo

Exchange rate

The exchange rate has remained relatively stable this year fluctuating around CDF551 per US dollar. Significantly large inflows of foreign aid should continue to drive the exchange rate through 2008. Since January 2008, the currency has depreciated marginally from an average of CDF547.78 per US dollar to an average of CDF551.76 per US dollar in June 2008. The improved security environment should put the country a step closer to the IMF PRGF programme. This should lead to more inflows of donor aid, which should continue to stabilise the exchange rate. Export revenues, especially from the mining sector, will also help to minimise any fall in the franc exchange rate. Also, because of high dollarisation of the economy, any high demand for Congolese franc for investment in the mining sector might not pose a significant threat to the stability of the currency.

Congolese franc/US$



Source: Bloomberg

Buoyant world commodity markets will continue to benefit the country. This should lead to a significant increase in export earnings from the mining sector thereby strengthening the currency. Continued regional capital inflows from within SADC should also support the currency. We expect the exchange rate to maintain its current levels throughout 2008.

Balance of payments

Even after failing to sign the Economic Partnership Agreement (EPA) within the Central African Monetary and Economic Community (CEMAC) in December 2001, effective January 2008, the government committed itself to strengthening agreements to enforce control of imported goods before shipping. This enforcement was expected to, among others, boost the collection of customs duties.

The stable macroeconomic environment and the overall improvement in the domestic economic and regulatory spheres continue to facilitate a better and more promising outlook in the DRC's trade account and terms of trade. The buoyant global commodity market has led to increased exports, especially in the mining sector. Exports, as a percentage of GDP, increased from 36.2% in 2006 to 45.1% in 2007. Overall, we expect exports to improve on the back of increased activity in the resources sector with its potentially large and untapped natural resources. Thus, government's commitment to infrastructure rehabilitation and rising world commodity prices should continue to boost not only diamond and crude oil exports but other minerals as well.

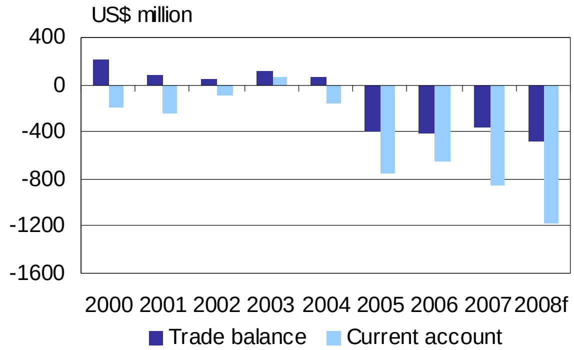
Recently, we also saw some reversal of fortune as the deficit in the trade balance continued to widen from 7.5% to 7.9% of GDP between 2006 and 2007. However, over the same period, the economy grew from 5.6% to 6.3%. The widening of the deficit in the trade balance is evidence of high import volumes as the country continues to source inputs for production. Equipment and raw material imports grew by 29.9% and 44.5% respectively during 2007. Overall, imports of goods and services, as a percentage of GDP, grew to 50.7% in 2007 from 41.3% in 2006.

Government's investment in infrastructure should continue to widen the current account deficit in the medium term. The country imports a lot of consumer and capital goods, which should lead to further deterioration in the trade balance. The overall imports of capital investment intended for the reconstruction of the economy will put more pressure on the trade deficit. However, continued investment in the mining sector should facilitate increased production, which should lead to an improvement in the current account position.

DRC continues to rely on the international donor community for funding of the growing costs of reconstruction. Buoyant commodity markets should help to ease the financing costs due to high export revenues. However, if the commodity market softens, this will put more pressure on the country's ability to finance reconstruction costs, thereby forcing the country to look at the donor community for assistance. We expect the foreign direct investment (FDI), mostly directed towards the mining industry, to increase in the medium term.

As the country moves closer to the PRGF programme, we expect an increase in donor assistance, which should lead to a sharp increase in current transfers. Over 90% of current transfers into DRC are official aid and a significant portion of that is used to pay for imports of goods and services. Continued reduction in total debt should increase the availability of more resources that can be directed into infrastructure investment.

Current account



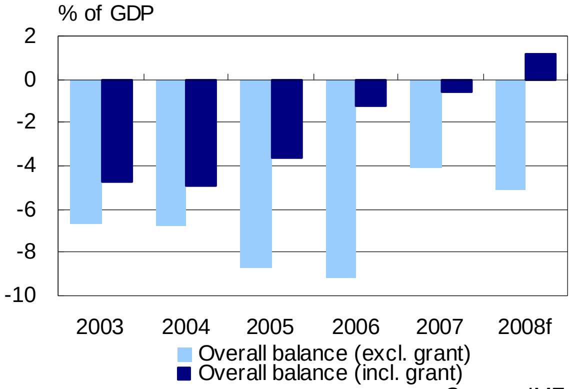
Source: IMF

Overall, we expect the capital account to improve due to both private and large donor inflows. Further increases in FDI should boost the capital account in the medium term, and we expect the current account deficit to continue to widen following the increased costs of reconstruction that are fuelling strong imports. The IMF estimates the current account deficit to average 12.9% in 2008 (10.5% including grants).

Government finances

Government fiscal space remains very limited and with a low tax base. However, the authorities continue to maintain macroeconomic stability that should translate into improvements in central government finances. Continued donor aid (totalling well over US$10 billion since January 2008) should ease the fiscal space. A return to the IMF PRGF programme should also help to increase the budget support as suspension of all lending facilities might be lifted. There is also a commitment to improving revenue collection, increasing expenditure oversight and expanding the revenue base. The renegotiation of mining contracts should significantly boost state revenue, as the mining sector revenue contribution is still small relative to the sector's size and importance on the economy. During 2007, we saw expenditure overrun mostly fuelled by continued conflicts and unrest in the eastern part of the country, establishment of provincial and local government offices and the increased government wage bill. The IMF forecasts the wage bill to average about 5.9% of GDP in 2008.

Fiscal balance



Source: IMF

Despite the many challenges the country faces during reconstruction, the public expenditure coverage continues to show some signs of improvement. The expenditure coverage is estimated to have increased to about 75% in 2007 compared with just over 50% in 2006. Government financial institutions continue to record significant improvements in revenue collection. The General Tax Department recorded about CDF256 million in 2007 compared with CDF157 million in 2006.

The government continues to reiterate its commitment to improving public financial management, limiting cash advances to budget-line items only, prioritising expenditure, and strengthening political institutions and ministries. The cost of rebuilding the country should remain high and the investment bill still requires massive injection of funds from the international donor community. Any threat to the fragile peace process might lead to further breakouts of conflict and unrest in the eastern part of the country. This might further destabilise the country's fiscal space thereby leading to increased fiscal deficit. Decentralisation of government operations to other regions should also lead to increased pressure on the budget and the fiscal administration, which is still weak. Excluding grants, we expect the fiscal deficit to widen further in the medium term and the government to still rely heavily on donor support for most of its budgetary needs.

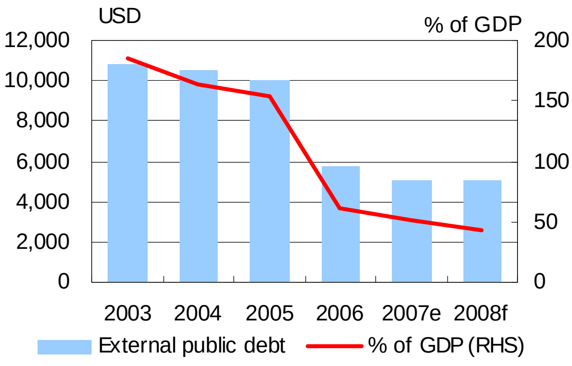
Selected economic indicators

	2003	2004	2005	2006	2007	2008f
Domestic economy (% unless otherwise stated)						
Real GDP growth	5.8	6.6	7.9	5.6	6.3	8.8
Consumer prices (annual average % change)	12.8	4.0	21.4	13.2	16.7	10.1
External sector						
Terms of trade (index, 2000=100)	124.6	129.0	143.6	152.3	192.3	185.0
Trade balance (% of GDP)	2.1-	0.9	-5.6	0.1	0.1	-1.1
Money and credit						
Broad money (M2) %	57.3	59.9	26.4	48.5	50.6	16.3
Broad money (M2) % of GDP	6.2	8.8	8.5	10.5	12.3	12.1
Central government finance(percent of GDP)						
Overall fiscal balance, incl. grants	-4.7	-4.9	-3.6	-1.2	-0.6	1.2
Overall fiscal balance, excl. grants	-6.7	-6.8	-8.7	-9.2	-4.1	-5.1
Balance of payments (% of GDP, unless otherwise stated)						
Current account balance, incl. grant	1.0	-2.4	-10.5	-2.4	-4.0	-10.5
Current account balance, excl. grant	-6.3	-7.9	-16.0	-10.2	-9.3	-12.9
Gross official reserves (end of period, US$ millions)	97.8	236.2	131.2	154.5	171.3	264.3
Reserves (months of import cover)	0.2	0.7	2.8	4.0	3.1	7.0
External debt indicators						
External debt stock (% of GDP)	184.7	164.3	154.4	60.4	51.4	42.5

Source: IMF

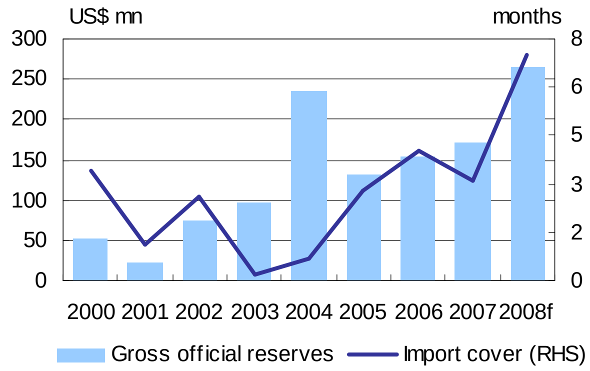
Picture Gallery

FIGURE 1: EXTERNAL DEBT



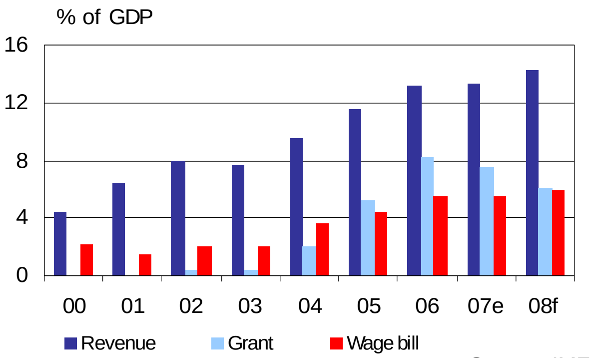
Source: IMF

FIGURE 2: FOREIGN RESERVES & IMPORT COVER



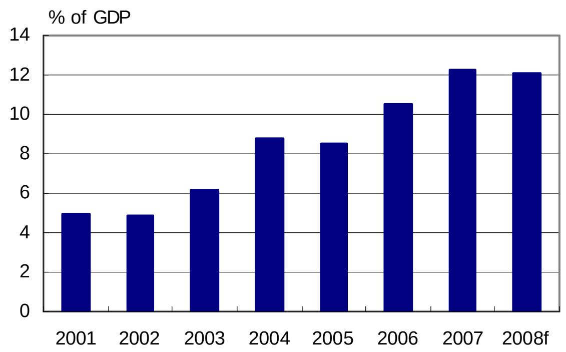
Source: IMF

FIGURE 3: GOVERNMENT FINANCE



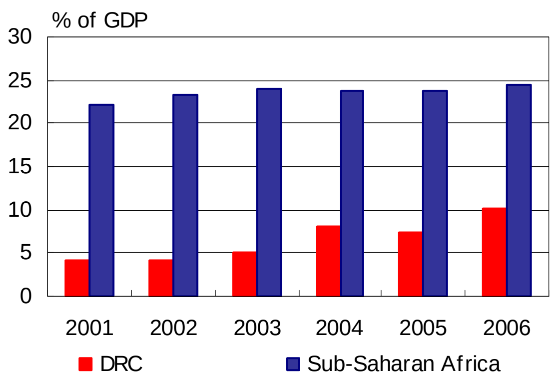
Source: IMF

FIGURE 4: BROAD MONEY GROWHT



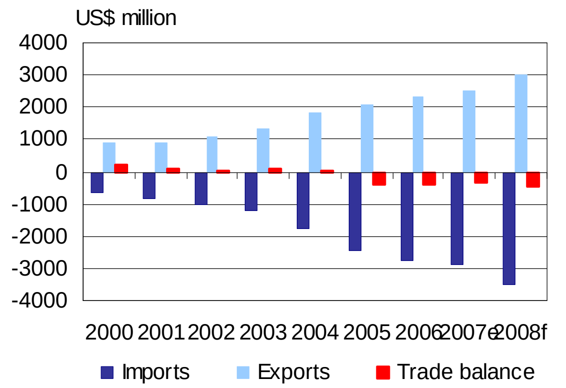
Source: IMF

FIGURE 5: BANKING ASSETS



Source: IMF

FIGURE 8: INTERNATIONAL TRADE



Source: IMF

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