ANNEX V

1. IDENTIFICATION

Title/Number	**SIERRA LEONE -** Multi Donor Budget Support (MDBS) Rider to the Financing Agreement CRIS number - 020-947		
Total cost	Rider: 12.000.000 – Revised value of Multi Donor Budget Support (MDBS): 58.400.000 EUR (39.000.000 GBS+7.400.000 Complementary PFM+12.000.000)		
Aid method / Management mode	General budget support – centralised management (39.000.000+12.000.000) Complementary support – decentralised management (7.400.000)		
DAC-code	51010	Sector	General Budget Support

2. RATIONALE AND COUNTRY CONTEXT

The purpose of the present amendment is to provide for an additional 2009 fixed tranche of 12.000.000 EUR to be disbursed in 2009 and increase the amount of the budget support allocation for Sierra Leone.

In the wake of the international economic and financial crisis, the EC Communication "Supporting development countries in coping with the crisis" (COM 2009-160 final) foresees the creation of the Vulnerability FLEX. The Commission decision "concerning an increase in allocation of resources for unforeseen needs from the 10th EDF to support the most vulnerable and less resilient ACP countries in coping with the impacts of the global financial crisis by setting up an ad hoc Vulnerability FLEX mechanism" dated 9th July 2009 details its rationale, eligibility criteria and modalities. The Vulnerability FLEX mechanism has set aside an amount of 500.000.000EUR from the reserve of the national and regional indicative programmes under the 10th EDF to respond to the impact of the global financial and economic crisis in the most vulnerable and less resilient ACP countries during the period 2009 and 2010.

In that context, the National Authorising Officer of Sierra Leone has requested on 27th July 2009 an exceptional additional support to mitigate the impact of the crisis. Considering article 2 (d) of the EC Decision granting the possibility to adjust eligibility threshold for Fragile States, Sierra Leone can be considered eligible under Vulnerability FLEX. The residual financing gap forecasted for 2009 is due to the Government of Sierra Leone's effort to safeguard the level of public expenditure to support growth and avoid major disruption in State services delivery. The capacity of the EC to quickly grant a critical support (see Allocation Decision for VF 2009) is critical to limit further cuts and/or costly domestic financing.

2.1. Country Context and National Policy and Strategy

2.1.1. Economic and social situation and poverty analysis

The global economic downturn has weakened Sierra Leone’s economic prospects for 2009 which is translating into an important loss of domestic revenues. In this context, fiscal policy will strive to maintain capital and poverty-reducing spending in 2009 while safeguarding macroeconomic stability. This will be achieved by accommodating the revenue shortfall through additional external financing, reducing some non priority spending, and raising domestic financing moderately depending on the availability of additional donor support like the Vulnerability-FLEX.

The Government of Sierra Leone has requested an exceptional support under the Vulnerability-FLEX to help mitigate the impact of the crisis by compensating revenue losses but, most importantly, to avoid being forced into additional domestic borrowings. The IMF programme indeed foresees that, in addition to an increased access by 0,4% GDP to domestic financing to close the financing gap identified in April 2009, the Government of Sierra Leone can compensate shortfalls in budgetary support by increasing domestic borrowing for a maximum amount of USD 20 million. This adjustment can also be applied downwards should budget support be in excess of what was budgeted.

- Vulnerability assessment. According to the March 2009 IMF study and a previous assessment by the DG Development A1, Sierra Leone faces a medium vulnerability risk to the crisis[1]. After several years of civil war, the country remains fragile. Economic and social stabilization is ongoing: the economy remains weak with an underdeveloped private sector, low domestic revenues, high dependence on oil imports, lack of major economic infrastructures and a looming energy crisis.

- Government request: The Government of Sierra Leone has requested support under the V-FLEX to help it cope with the ongoing crisis. The Government's strategy is based on "*a combination of revenue enhancing measures, identifying additional external budget support, reducing recurrent spending, increasing bank financing and further draw down of MDRI resources*". Cuts in goods and services expenditures in the area of defence, police and prisons amount to Le7.2 billion (1.600.000EUR), while an effort is made to keep poverty-related expenditures at the originally budgeted level (Le330 billion, i.e. 77.300.000 million). This latter effort causes a financing gap of Le22,3 billion which the Government of Sierra Leone has been allowed to finance through increased draw down on MDRI resources, bring domestic financing up to 1.7% what is not well sustainable given the high use of domestic financing in 2008 (2,7% GDP). As explained above, the IMF also considered that the recent pattern of volatile budget support disbursements represented a high risk to the fiscal equilibrium and cash flow management and has allowed the Government to compensate budget support shortfalls with increased domestic financing by up to 20 MUSD. However, the Government of Sierra Leone as well as the IMF recognises that resorting domestic financing is a costly operation that could have adverse impacts on the private sector, consumer prices and public debt.

Finally, the Government of Sierra Leone also rightly insists that" *cutting expenditures to close the fiscal gap would not only be pro-cyclical, but severely harmful to the national poverty reduction agenda. In particular, reducing goods and services expenditures would adversely affect the provision of basic services, (...) and could potentially undermine poverty reduction efforts and risks social and political stability*". In conclusion, the Government of Sierra Leone requests 12.000.000 EUR to avoid having to resort to additional costly domestic financing and be able to maintain the forecasted level of expenditures. The VLEX contribution aims to close the entire residual financing gap in view of the impossibility of other donor contributions to the country and taking into account its inability to resort to external borrowing.

- Description of the impact of the crisis. Sierra Leone is more affected by the crisis than foreseen at the end of 2008. Exports have fallen significantly (rutile, diamond, bauxite) in price and volume. The mining sector has been particularly hit by declining world market prices and scaled back production. Real GDP growth is projected to slow to 4% (against 5, 5% forecasted). External current account deficit is expected to widen (-12.3% of GDP against -8.1% forecasted). Imports are also declining as growth and oil prices go down. Although excise taxes on fuel imports were raised earlier this year, domestic revenue is expected to fall short of the initial target by Le 99 billon (32 MUSD), mainly because of the downward revision of exports and imports, and weaker income growth. Out of the total revenue short fall ($32 million), $20 million is estimated to be linked to the crisis. As no expansionary

[1] "The Implications of the Global Financial Crisis for Low-Income Countries ", IMF March 2009.

budget was possible, total expenditure are reduced by Le 24 billion compared to the initial budget. In response to the deterioration, the 2009 fiscal framework has been revised and the fiscal gap was officially closed as a precondition for the IMF Board, June 17th. 2009 financing needs are financed with important domestic financing, donor support (EC 2008 fixed tranche disbursed in January 09 that covered 2008 arrears, Peace Building Fund covering additional energy expenditure, DFID disbursement of its performance tranche in full to partly offset losses due to £ lower exchange rate) and expenditure cuts (including unexpected reduced interest rates). The residual fiscal gap of Le22.3 billion (5.000.000 EUR) will be financed with additional domestic financing (that will be increased from 1.3 to 1.7% of GDP) if no additional support can be mobilized.
Although, the Government of Sierra Leone has systematically given priority to the payment of civil servants' salaries whenever he was faced with revenue shortfalls, the current crisis might put the Government in a difficult position if foreign aid is not rapidly increased. Moreover, a worsening economic environment coupled with cuts in goods and services expenditures may lead to the multiplication of social tensions.

- V-FLEX eligibility: Sierra Leone is considered eligible under the VF due to: 1) its economic vulnerability, demonstrated by falling domestic revenues (by 1,3 % of GDP; from 12,3% of GDP initially forecasted to 11% of GDP in the revised budget)[2] and a widening public deficit (excluding grants) by -1.8 % of GDP (from -9,4% to 11,2% of GDP in 2009). In accordance with Art 2.1.d of the EC decision, the vulnerability thresholds under the first criteria should be adapted to take into account the particular situation of a Fragile State like Sierra Leone; 2) With 20 MUSD revenue losses due to the crisis and after having reduced expenditure, the IMF agreed upon covering the residual financing gap of Le22 billion (5.000.000 EUR) by additional domestic financing hoping that additional budget support could be found and knowing that further shortfalls in revenue or in budget support would reopen the gap; 3) the consideration that the EC could give a critical support to cover this gap, compensate revenue losses and limit resort to domestic financing with a view to maintaining priority expenditures within a very tight budget; and 4) the existence of budget support programs under the 8th, 9th and 10th EDF, demonstrating absorption capacity.

- <u>Poverty:</u> The UN Human Development Index 2008 ranked Sierra Leone as the least developed country in the world (179), with 70% of the population below the national poverty line (average during the period 2000-2007). In this context, it is essential to protect core social services. Poverty-related expenditures (health, education, and transfers to local councils) have been seriously affected by revenue shortfalls in previous years already and 2009 should be no exception.
In 2009, wages and salaries will amount to Le 400.2 billion, accounting for 40 percent of recurrent expenditures and 55.2 percent of domestic revenue. Government is committed to protecting wages and salaries of civil servants even in times of crisis. However, falling domestic revenues are putting pressure on the overall level of social expenditures. The Government however also committed that priority poverty-related expenditures will be protected[3]. These two commitments contribute to increasing the fiscal deficit for 2009. Moreover the recently adopted Agenda for Change foresees increased capital investment in infrastructure, which is believed to be conducive to growth and job creation. However, the ongoing crisis is undermining Government’s ability to cover these expenditures.

2.1.2. <u>National Development/ Cooperation Policy and Strategy</u>

<u>National policy and strategy:</u> The first Government of Sierra Leone Poverty Reduction Strategy Paper (2005-2007) was extended until the adoption of the new one (PRSP II) covering 2009-2013. The PRSP II operates a shift towards a strategy aimed at enabling economic growth as a way to reduce poverty. A Consultative Group meeting will be help on London in November 2009.

---

[2] Domestic revenues fall by 1,3% of GDP if one compares the initial domestic revenue projections (made in September 2008) and the revised projections (established in April 2009).
[3] Poverty related expenditure amount Le330 billion, of this, Le65.4 billion is allocated to education, Le39.8 billion to health and Le60.1 billion as transfers to local councils. Spending the education sector covers school fees subsidy and provision of teaching and learning materials and text books to primary schools. In the health sector, free drugs are provided to the vulnerable.

National Budget and medium term financial perspectives: National budget remains highly dependent on external aid. The objective of the Government of Sierra Leone to restore budget credibility and macroeconomic stability has been put under strong pressure by the global crisis because of the strong shortfall of domestic revenue (-1.3% GDP). Along with expenditure cuts and call on donor support, fiscal and PFM measures have been strengthened to avoid further decline of revenue.

Performance Measurement: Government of Sierra Leone and Development Partners hold regular (quarterly) budget execution monitoring meetings. The macroeconomic situation is also followed by the IMF in the context of a PRGF programme. MDBS partners also use a Performance Assessment Framework whose latest review took place in June 2009.

2.2. Eligibility for budget support

In the framework of the Country Strategy Paper of the 10th EDF and the 2008 Annual Action Plan, Sierra Leone is currently benefiting from EC BS programme signed on 22 April 2009.

On the basis of the analysis in Section 2.1.1, Sierra Leone is deemed to be eligible for Vulnerability FLEX

2.2.1. National Development or Cooperation Policy and Strategy

The PRSP II covering 2009-2013 is in place and under implementation in Sierra Leone.

2.2.2. Macroeconomic situation

Despite a deteriorating external context (see 2.1.), the Government of Sierra Leone is responding to the crisis by establishing an adequate fiscal policy supported by donors and using domestic and external financing when possible. These efforts to maintain macroeconomic stability were confirmed by the approval of 4th review of the PRFG by the IMF Board, 17th June 2009. The IMF mission for the 5th review in September concluded that it remains well on track.

2.2.3. Public Financial Management

A PFM-PEFA Performance Assessment Report was carried out in December 2007. Sierra Leone has made progress in PFM reforms in the last few years monitored in the wider context of the MDBS. The PFM National Action Plan implemented in 2006-2007 delivered reforms in a number of areas. In order to consolidate the improvements made and coordinate donor interventions to further PFM strengthening (budget execution, planning, etc) the Government of Sierra Leone has prepared an Integrated PFM Reform Programme (IPFMRP) supported by donors. It should be enforced in 2009. The progress made under the NAP, its following reform and the joint approach of PFM in Sierra Leone contribute to meet this eligibility criteria.

2.3. Sector Policies (where appropriate)

Budget support and PFM are notably linked to other sector policies such as the civil service reform, the fight against corruption or energy. Social sector policies need to be further developed.

2.4. Lessons learnt

In the aftermath of the food and oil crisis and the current crisis, it has been demonstrated that core spending needs to be sustained during the crisis (unless the shock is judged to be permanent), if current development gains are to be protected and long term development goals achieved.

2.5. Complementary actions

In the context of 2008 food and oil crisis, Sierra Leone received 6.420.000 EUR as additional budget support through the mobilization of B-envelope that should be disbursed in Q4 2009. Sierra Leone will also benefit from 16.200.000 EUR under the Food Facility in projects.

In 2009, donors have granted additional support to help mitigating the crisis: the IMF has increased access to the PRGF by 15M$, UK will release only its full performance tranche in 2009. The WB may keep its BS at the previous level of 10 M$. AfDB has recently disbursed 8.5 M$, 0.5 M$ than initially budgeted.

2.6. Donor coordination

The Commission, in close cooperation with international organisations and notably the IMF and the World Bank, has assessed the impact of the global financial and economic crisis on the ACP States, concluding that the crisis may adversely affect macro-economic stability and progress towards achieving the millennium development goals in many of the countries.

In Sierra Leone a coordinated approach between the Commission, the IMF, the World Bank, UK and the AfDB is particularly needed. WB and EC headquarters participated to the 2009 MDBS annual review. The IMF was closely associated to the preparation of the V-FELX. This close coordination will continue all along the Vulnerability FLEX process to ensure that donor responses attain the highest benefits for this affected countries.

The Memorandum of Understandings for budget support (WB, AFDB, EC, DIFD) is being revised.

3. DESCRIPTION

3.1. Objectives

The overall objective of the present rider is to further support the implementation of macro-economic and fiscal policy driven by the Government of Sierra Leone to mitigate the impact of the crisis on the country. The European Commission short-term support provided through the Vulnerability FLEX will be critical in order to reduce significantly the need of the Government to use domestic borrowing to maintain priority expenditures in 2009, especially social spending.

3.2. Expected results and main activities

The expected result is to reduce the negative impact of the crisis on a fragile country facing economic and social vulnerability risks and contribute to its macroeconomic stability. Concretely, and against a background of potentially growing fiscal financing gaps that will only be closed by domestic borrowing, the Commission intervention will limit the resort to costly domestic borrowing that could have adverse effect on the private sector and inflation. It is also expected from this EC intervention that actual poverty-related expenditures will match budgeted levels.

3.3. Stakeholders

The main stakeholders of GBS/PFM will be the Government of Sierra Leone and primarily the MoFED and other DPs and the IMF. Ultimately, the population of Sierra Leone will benefit from this BS operation.

3.4. Risks and assumptions

The risk related to the conclusion of the next (5^{th}) PRGF review is rather limited. The global recession may affect the Sierra Leonean economy more severely than projected or may further disturb an already fragile fiscal framework. In this context, securing revenue and following closely on budget execution has become even more critical. The financial crisis could also impact negatively on the balance sheet of commercial banks, constraining the availability of bank credit. The BSL is closely monitoring developments in the financial sector.

Strengthening PFM and budget execution is a key issue. The strong push and donor support to PFM is a very useful tool to pursue the reforms. Budget follow up meetings need to be kept.

Finally, economic governance issues or corruption remains a risk.

3.5. Crosscutting issues

The EC budget support should generate positive results at political, economic and social levels. In particular, the IPFMRP should foster transparency and accountability in the use of public funds and thus improve good governance practices. Moreover, there is a specific "gender oriented" indicator in the PAF 2009.

4. IMPLEMENTATION ISSUES

4.1. Budget and calendar

In addition to the 46.400.000 EUR originally provided under the Multi Donor Budget Support (MDBS), the present amendment will increase the budget support component by 12.000.000 EUR to 58.400.000 EUR. The revised disbursement profile of the MDBS is presented in the table below.

MULTI DONOR BUDGET SUPPORT financial design (in M EUR)

	2009	**2010**	**2011**	**Total**	*Share*
Fixed tranche	10,00	9,00	9,00	**28,00**	*55%*
Fixed tranche – B envelope Vulnerability Flex	12,00	-	-	**12,00**	*24%*
Variable tranche (max.)	3,00	4,00	4,00	**11,00**	*22%*
Total budget support	***25,00***	***13,00***	***13,00***	***51,00***	***100%***
Share	*49%*	*25%*	*25%*	***100%***	
IPFMRP – Trust Fund to World Bank	2,00	2,00	2,00	**6,00**	
Technical Assistance	0,90	-	-	**0,90**	
Evaluation	-	0,25	-	**0,25**	
Audit	-	-	0,15	**0,15**	
Communication and visibility	0,10	-	-	**0,10**	
TOTAL PROGRAMME	**28,00**	**15,25**	**15,15**	**58,40**	

4.2. Budget support modalities

The action consists of a direct and untargeted budget support, according to the modalities agreed upon on the Vulnerability FLEX decision.

4.3. Procurement and grants award procedures

The provisions of the Multi Donor Budget Support (MDBS) in this regard remain unchanged.

4.4. Performance monitoring and criteria for disbursement

The disbursement of this additional 2009 fixed tranche will be guided by the provisions of the Multi-Donor Budget Support (MDBS) Financing Agreement. In this context, the disbursement will be conditional upon fulfilment of the eligibility criteria to receive budget support: (i) satisfactory progress in the implementation of the national development strategy or of the subsequent strategy; (ii) satisfactory progress in the maintenance of a stability-oriented macroeconomic policy; (iii) satisfactory progress in the implementation of its programme to improve PFM.

4.5. Evaluation and audit

The provisions of the Multi Donor Budget Support (MDBS) in this regard remain unchanged.

4.6. Communication and visibility

The action will receive specific press coverage as it comes in addition to the tranches already provided under Multi-Donor Budget Support program and as it is justified by peculiar circumstances.