September 2006
IMF Country Report No. 06/334

Cape Verde: 2006 Article IV Consultation and Request for a Three-Year Policy Support Instrument—Staff Report; Staff Statement; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Cape Verde

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2006 Article IV consultation with Cape Verde and its request for a three-year Policy Support Instrument, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation and request for a three-year Policy Support Instrument, prepared by a staff team of the IMF, following discussions that ended on May 16, 2006, with the officials of Cape Verde on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 14, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of July 31, 2006 updating information on recent developments;
- a Public Information Notice (PIN) and Press Release summarizing the views of the Executive Board as expressed during its July, 31, 2006 discussion of the staff report that concluded the Article IV consultation and the request, respectively.
- a statement by the Executive Director for Cape Verde.

The document(s) listed below have been or will be separately released.

Statistical Appendix
Joint Staff Advisory Note (JSAN)
Poverty Reduction Strategy Paper (PRSP)—First Annual Progress Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

Cape Verde

Staff Report for the 2006 Article IV Consultation and Request for a Three-Year Policy Support Instrument

Prepared by the African Department
(In consultation with other Departments)

Approved by David Nellor and Anthony Boote

July 14, 2006

- **Discussions**. Discussions for the 2006 Article IV consultation and on a medium-term economic program that could be supported by a three-year Policy Support Instrument (PSI) were held in Praia on April 28–May 16, 2006. The team comprised Mr. MacFarlan (head), Mr. Maehle, Ms. Karpowicz, Mr. Franken (all AFR), and Mr. Saab (MFD).
- **Fund relations**. The 2005 Article IV consultation and final review of Cape Verde's three-year PRGF arrangement were concluded in May 2005. The PRGF arrangement ended on July 31, 2005. Cape Verde's use of Fund resources stood at SDR 8.64 million (90 percent of quota) on December 31, 2005. Cape Verde has accepted the obligations under Article VIII of the Articles of Agreement and maintains a fixed exchange rate that is free of restrictions in the making of payments and transfers for current international transactions.
- **Last Board discussions.** Directors commended the authorities for Cape Verde's strong policy performance during the PRGF arrangement, which helped correct the imbalances that followed the 2001 elections. Directors urged the authorities to consolidate the progress made in recent years by maintaining a sound fiscal stance, supporting exchange rate stability through further accumulation of international reserves, and pushing ahead with their structural reform agenda.
- **Recent economic developments.** Economic and policy performance remains strong. Growth in 2005 was nearly 6 percent, fiscal restraint was maintained through the recent elections, and international reserves are accumulating. Pass-through of high international oil prices will, however, result in lower growth in 2006 and substantially higher inflation.
- **Objectives of the PSI.** The PSI program seeks to support the development strategy the authorities set out in the PRSP through policies to reduce macroeconomic risks, provide a margin of safety against exogenous shocks, and address the prospect of a longer-term decline in highly concessional external support. Priority measures the authorities outline in their request for a PSI are (i) reducing public debt; (ii) building up international reserves; (iii) rationalizing the system of tax exemptions; (iv) implementing the automatic mechanism to adjust electricity and water tariffs; (v) improving public financial management; and (vi) strengthening capacities and regulation in the financial sector, especially for the offshore financial center.
- **Currency:** The Cape Verde escudo has been pegged to the euro at a rate of CVEsc 110.3 per €1 since 1999.
- Upon approval of the PSI, Cape Verde would resume the 24-month cycle for Article IV consultations.
- **Publication**. The authorities have agreed to publish the staff report and their request for a three-year PSI.

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EXECUTIVE SUMMARY

Cape Verde's economic and policy performance has strengthened significantly in recent years, supported by reforms pursued under the country's first Poverty Reduction and Growth Facility (PRGF) arrangement. International reserves have increased, adding credibility to the exchange rate peg to the euro. The fiscal position has improved and, in a marked break from the past, fiscal restraint held firm through the recent elections. Privatization and other structural reforms are moving ahead. Reflecting the improved policy environment, growth has averaged around 5 percent since 2000, supported by strong inflows of external financing from both private and official sources.

The Article IV consultation considered the key issues that will shape the economic and policy environment in the years ahead. With the goal of accelerating growth and reducing poverty within a stable macroeconomic environment, policy priorities include safeguarding the exchange rate peg, managing fiscal pressures and risks, and strengthening public sector management. The authorities and staff agreed that specific emphasis also needs to be placed on developing human capital, improving the business climate, supporting financial sector development, and ensuring adequate supplies of energy.

The Article IV consultation formed the backdrop for discussions on a government program that could be supported by the IMF through the Policy Support Instrument. Cape Verde appears well-suited to a PSI: it has largely achieved macroeconomic stability; it does not need or want financial assistance from the Fund; but the authorities would like to stay in close dialogue with the Fund—both to support policy development and to signal to the international community its commitment to sound policies.

To help Cape Verde prepare for the development opportunities and challenges it faces in the coming years, policies pursued under the PSI would focus on:

- Supporting the exchange rate peg by increasing foreign reserve coverage and strengthening the operation of monetary policy.
- Creating fiscal space to manage potential pressures on spending or access to concessional external financing by, for example, reducing government debt as a share of GDP, better prioritizing expenditures, and rationalizing tax exemptions.
- Strengthening public sector management through measures to improve capacities and procedures for budget management, and through civil service reforms.
- Addressing risks to growth and to the fiscal position arising in public service enterprises, including by improving the regulatory framework for the energy sector and restructuring the national airline.
- Improving the business environment, in part by reducing administrative barriers, increasing labor market flexibility, and strengthening vocational training.
- Ensuring that financial sector development—both among domestic banks and in the rapidly growing offshore financial sector—takes place within an institutional framework that is in line with international best practices.

I. INTRODUCTION

1. **The cornerstones of Cape Verde's economic strategy are sustained macroeconomic stability and structural reforms in support of private sector-led growth.** Reforms pursued under the Poverty Reduction and Growth Facility (PRGF) arrangement that ended last year focused on fiscal consolidation. Public spending was restrained and revenue collection improved to correct the severe macroeconomic imbalances that had emerged in 2000–01. With the strengthening of the fiscal position since 2001, Cape Verde has built up its international reserves and grown in policy credibility. As a result, Cape Verde has experienced sizable inflows of external finance for investment and development, solid growth averaging around 5 percent since 2001, low inflation, and a reduction in poverty. Cape Verde was one of the first countries to receive support from the Millennium Challenge Account (MCA) in 2005 and is eligible for further MCA support under a new category created for lower middle income countries.[1]

2. **To underpin and signal its commitment to sound economic policies, the government has requested a three-year Policy Support Instrument (PSI).** The authorities note that macroeconomic stability has been achieved; IMF financial resources are not needed; but the government wants to stay in close dialogue with the Fund as it continues to strengthen the country's economic and policy performance. The government also points out that Cape Verde continues to face large development challenges. Despite recent progress, unemployment and poverty are still high; and because the country consists of many small islands, improving infrastructure, public services, and other aspects of sustainable growth and poverty reduction is inherently slow and costly. To address these and other challenges, Cape Verde will continue to rely heavily on external support.

3. **The program to be supported by the PSI would provide a coherent economic policy framework for the government's medium-term development objectives.** In particular—as outlined in the attached Memorandum of Economic and Financial Policies (MEFP)—the program is designed to enhance the sustainability of growth and development by maintaining a stable macroeconomic environment and moving forward with structural reforms. Specific attention is given to reducing fiscal risks and giving Cape Verde a margin of safety to protect the economy against exogenous shocks. The macroeconomic framework would also help prepare Cape Verde for the prospect that—as GDP per capita continues to rise—the country's access to highly concessional external finance may fall.

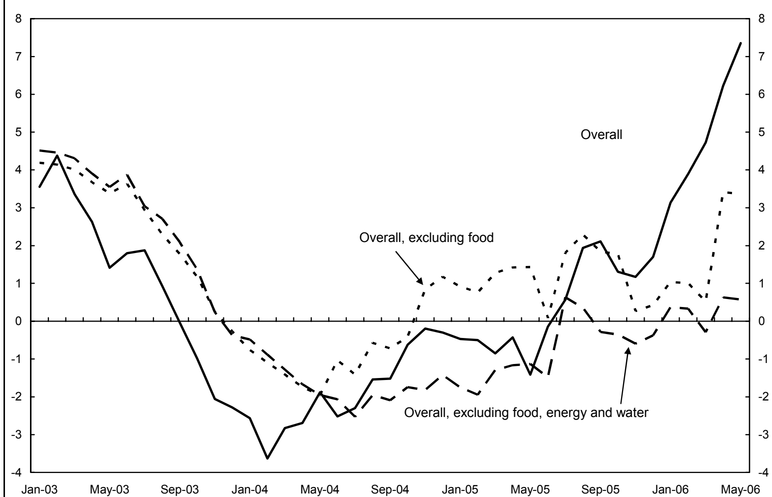
II. RECENT DEVELOPMENTS

4. **The Cape Verde economy continues to perform well, although it is now experiencing with a lag the impact of higher international oil prices**. Growth is estimated to have picked up to nearly 6 percent in 2005, supported by increased private investment—

[1] The 2005 grant is for US$110 million (around 11 percent of GDP), to be spread over 4–5 years. This is being directed mainly toward infrastructure projects, including port development and rural irrigation, and capacity building in public administration.

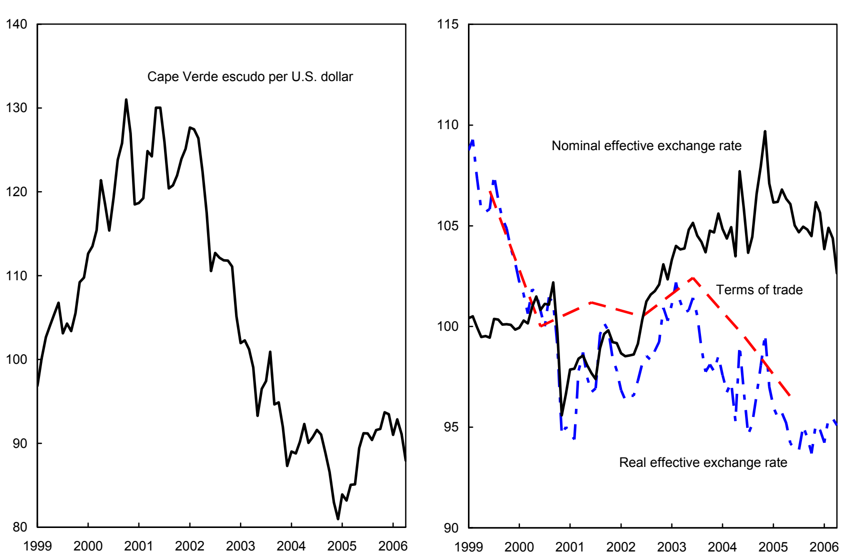
mainly for tourism-related construction—and a higher execution rate of public investment. Prices fell for much of 2003–05 but have recently increased sharply: the CPI rose by 7.4 percent in the year to May 2006, mainly reflecting higher food prices—driven by temporary shortfalls in the supply of fish, fresh fruits and vegetables, and imported sugar—and increases in regulated petroleum prices. Excluding these factors, the CPI increased by only 0.6 percent (Figure 1). The CPI is expected to increase further after the June 2006 adjustment of electricity and water tariffs (see below). In the year to April 2006, the real effective exchange rate depreciated by 0.1 percent, primarily due to changes in the euro-dollar exchange rate (Figure 2).

Figure 1. Cape Verde: CPI Inflation Rates, 2003–06
(Percentage change from the same period of the previous year)



Sources: Cape Verdean authorities, and staff estimates.

Figure 2. Cape Verde: Exchange Rates, 1999–2006
(Index, 2000 = 100)

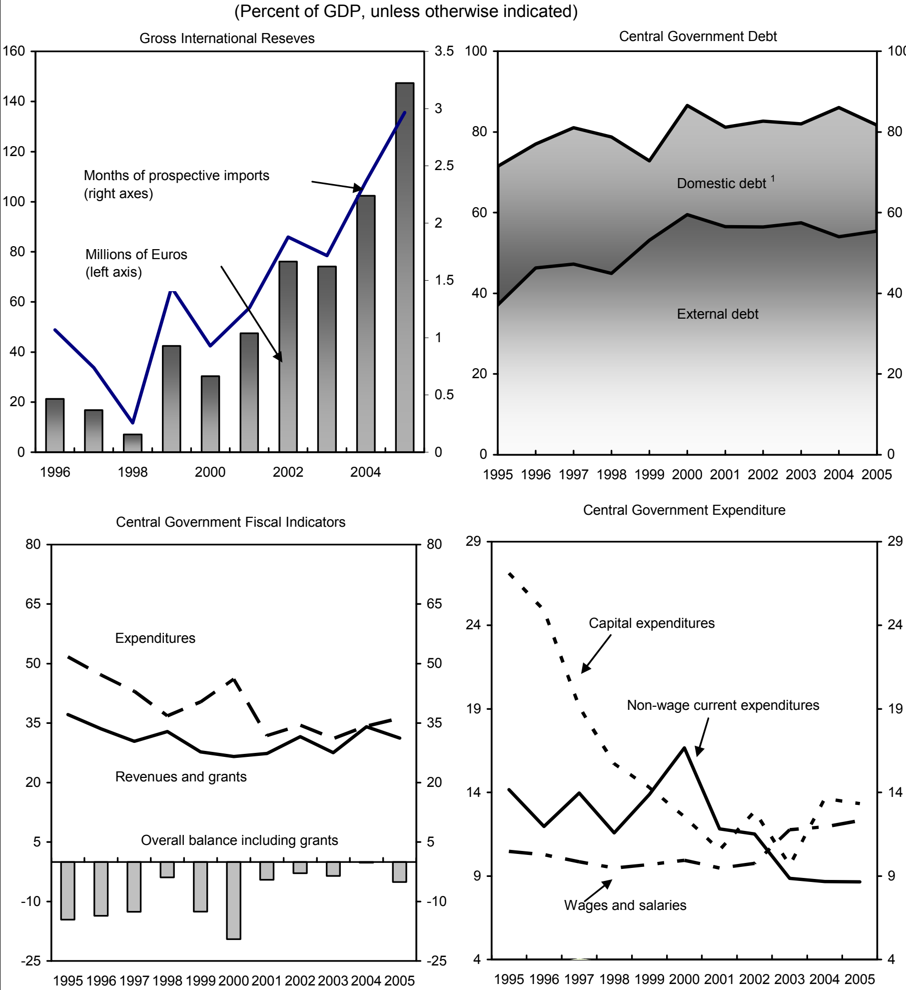


Sources: International Financial Statistics, and Information Notice System.

5. **In a marked break from the past, the authorities maintained a prudent fiscal stance through the recent election cycle** (Figure 3). Notwithstanding strong domestic revenues and prudent spending, however, the fiscal deficit reached 5.1 percent of GDP in 2005, mainly reflecting an increase in the provision of concessional external loans and a delay in the disbursement of budget grants. Still, sales of government financial and nonfinancial assets enabled net domestic borrowing, excluding for arrears clearance, to decline to -0.2 percent of GDP. As a result, domestic debt (including arrears, but net of deposits) fell slightly although, at around 33 percent of GDP at end-2005, it was still close to the level before the domestic debt reduction operation in the late 1990s. While exceptionally low interest rates have contained domestic interest payments, other spending components are beginning to create fiscal pressures. In particular, the government wage bill has continued to increase, recently because of promotions and hiring of security personnel and teachers toward the end of 2005.

Figure 3. Cape Verde: Selected Macroeconomic Indicators, 1995–2005

(Percent of GDP, unless otherwise indicated)



Sources: Cape Verdean authorities, and staff calculations.

[1] Including domestic arrears and excluding government deposits.

6. **The external current account deficit fell from over 14 percent of GDP in 2004 to 4.6 percent in 2005.** Growth in exports and remittances was stronger, and a broader market base has allowed importers to draw on cheaper and more diversified sources of supplies. As a result, exports of goods and services grew by 20 percent from 2004 to 2005, while imports grew by only 0.5 percent in nominal terms. Reflecting the improvements in the current account, international reserves rose from 2.4 months of prospective imports in 2004 to 3.0 months in December 2005.

7. **The excess reserves of commercial banks have increased significantly** because of strong net foreign exchange inflows, a lower reserve requirement,[2] and a slowdown in the growth of private sector credit in the first part of 2005 (Figure 4). Against this backdrop, Treasury bill rates declined sharply from 5.0 percent in April 2005 to 2.0 percent in April 2006; this is significantly below deposit rates. Actual lending rates have also markedly declined. Concerned about the potentially adverse effect on their deposit base, and emigrant deposits in particular, banks have only marginally lowered deposit rates. They have reacted to growth of excess liquidity by sharply increasing their holdings of foreign assets and pursuing domestic lending opportunities more aggressively, particularly consumer lending. The Bank of Cape Verde (BCV) has started to sell central bank securities to partially absorb excess liquidity.

8. **Financial services have continued to develop.** There has been rapid growth in the offshore financial sector, which now comprises five operating banks (several others are licensed but not yet operational). The payment system has been modernized with the creation of a network of automatic cash counters and expansion of international credit card services; and the Cape Verde stock exchange has been revitalized. Total banking sector assets have grown by 20 percent since end-2004 to reach over 90 percent of nominal GDP; growth is heavily concentrated in lending to the real estate and construction sectors. Emigrant deposits continue to play a critical role, accounting for over 40 percent of total deposits. Because of tightened interest spreads and excess liquidity, the profitability of domestic commercial banks suffered significantly in 2005, although prudential indicators remain sound (see Table 6).

9. **Structural reforms are moving forward.** The government has selected a new management team to restructure the national airline TACV in preparation for privatization; bidding is getting under way for privatizing the port operator, ENAPOR; and the remaining four companies on the government's privatization agenda are expected to be either liquidated or sold later in 2006. Following the 2003 Country Financial Accountability Assessment (CFAA), the authorities have completed a detailed action plan to build capacity in public finance management, have established a civil servants database, and are preparing to reform the number, allocation, and remuneration of civil servants. They are also pursuing a wide range of measures related to Cape Verde's accession to the WTO—expected to be voted on by WTO members in July 2006—including a proposal to further reduce external tariffs.

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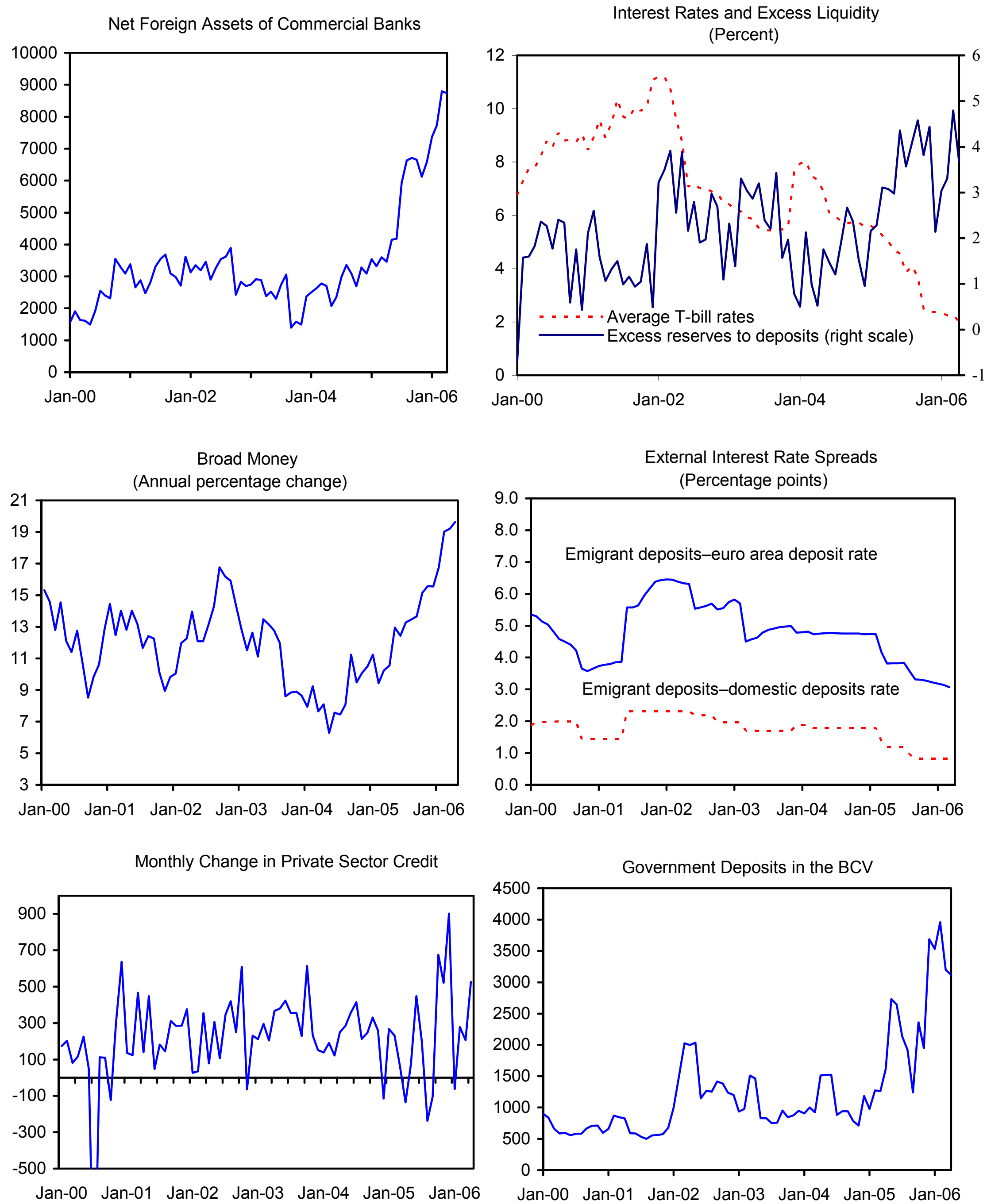
[2] The primary reserve requirement was reduced from 19 percent to 18 percent of deposits in November 2004, to 17 percent in June 2005, and to 15 percent on March 1, 2006.

Figure 4. Cape Verde: Selected Monetary Indicators, 2000–06

(Millions of escudos, unless otherwise specified)



Sources: Bank of Cape Verde, and staff calculations.

10. **Steps have been taken to clear the backlog of government accounts.** Draft accounts for 1998–2003 have been submitted to parliament for transmittal to the Court of Auditors (TdC), and provisional quarterly accounts for 2004 and 2005 have been submitted to parliament. Despite this progress, concerns remain about capacity constraints in the TdC and the Inspectorate General of Finance, and about large statistical discrepancies in the provisional quarterly accounts. Actions to address these concerns are part of the government's new program.

11. **An action plan has been prepared to settle public cross-debt.** A recent study found total net central government debt to the municipalities, the social security fund (INPS), and public and parapublic enterprises of CVEsc 5.9 billion. The government has agreed to settle CVEsc 4.8 billion (equivalent to 5.5 percent of GDP) of this; the rest is disputed.

12. **There has been progress in addressing the lingering conflict between the government and the majority private shareholders of Electra** (see Box 1). After the government decided to eliminate fuel subsidies—including those for electricity and water generation (by desalinization)—starting June 1, 2006, water tariffs were increased by 13.3 percent and electricity tariffs by 25.4 percent at the end of May. The autonomous economic regulatory authority (ARE) has signaled its commitment to fully implement an automatic mechanism for adjusting these tariffs to ensure that electricity and water prices reflect input cost changes and provide incentives for efficiency improvements.

Box 1. Update on Electra

The government and Electra's private majority shareholders reached agreement in June 2005 on the tariff deficit that the government owed to Electra because electricity and water tariffs were not adjusted in 2000–02.[1] The settlement of US$10 million is being paid to Electra in five equal annual installments starting in 2006. Additional outstanding government liabilities to Electra of about US$5 million comprise:

- US$2.5 million for unpaid electricity and water bills of central government, parastatals, and other public entities
- US$2.5 million for VAT refunds and revenue losses following the introduction of the VAT. Electra was required to pay VAT without any adjustment to the tariff structure.

The June 2005 agreement also addressed the recapitalization of Electra. The government has recently paid its share in this recapitalization, amounting to US$3 million.

Municipalities have built up considerable arrears with Electra for their consumption of electricity and water, a result of weaknesses in financial discipline and their small revenue base. Not including their share in the recapitalization of the company, which amounts to US$1 million, municipalities' debt to Electra is believed to be around US$3 million. The central government is urging municipalities to clear their arrears and, as noted in the MEFP, is taking steps to ensure they remain current in electricity and water payments.

[1] For further details, see the Staff Report for the Fifth Review of the PRGF Arrangement (www.imf.org), Box 1.

III. Accomplishments Under the PRGF Arrangement

13. **When Cape Verde's first PRGF-supported program was put in place, the country was facing severe macroeconomic imbalances in the wake of the 2001 elections.** Since then, economic and policy performance has been strong. The overall results under the program were considerably better than anticipated and the country has been receptive to the Fund's policy advice. Solid growth, supported by strong official and private capital inflows, has significantly alleviated poverty since the early 1990s. As a result, Cape Verde is about to graduate to middle-income status[3] and is on target to reach most of the Millennium Development Goals (MDGs) before 2015—including the target of cutting poverty in half. Reaching the MDGs in areas such as health, education, and sanitation will, however, place major pressures on public spending to strengthen infrastructure and the volume and quality of services.

14. **The lynchpin of the economic strategy under the PRGF arrangement was the recognition that disorder in public finances and debt overhang fundamentally constrained policies and required a multiyear fiscal consolidation.** The strengthening of the fiscal position since 2001 has supported a substantial buildup in international reserves. Improved policy credibility has helped attract increased private investment, sizable inflows of official aid and remittances, and emigrant deposits.

15. **Important progress has also been made with structural reforms.** A major focus has been on regularizing the public sector's relationship with large state-owned and public service enterprises to reduce fiscal risks and improve the efficiency of services. From forty a decade ago, only six enterprises remain on the government's privatization agenda, which should be completed in 2006–07.

IV. Policy Discussions: Setting the Stage for the PSI

16. **As backdrop for discussions on a PSI, the 2006 Article IV consultation considered the key challenges that will shape the economic and policy environment in the years ahead.** These challenges include:

- accelerating growth and reducing poverty, while consolidating macroeconomic stability;
- safeguarding the exchange rate regime;
- managing fiscal pressures and risks through, e.g., creation of fiscal space against future contingencies and reduction of central government debt; and
- strengthening public sector management, notably by improving capacities for financial management and pushing ahead with comprehensive civil service reform.

[3] Cape Verde will graduate from the group of less advanced countries to middle income status (as defined by the United Nations) in 2008, following a UN resolution to this effect in December 2004.

The government's strategy for tackling these challenges is set out in its Poverty Reduction Strategy Paper (PRSP) and the recent PRSP Progress Report.[4] The main elements of this strategy are summarized below and then brought together in the discussion of the specific objectives and criteria of the PSI program.

Box 2. IMF-World Bank Structural Conditionality

The IMF and World Bank cooperate closely on Cape Verde's structural reform program. Program design and the conditionality of the Bank and Fund are fully consistent.

IMF Conditionality

Under the PRGF arrangement

- Conditionality was aimed at deepening fiscal consolidation; strengthening monetary policy; improving the efficiency of tax and tariff structures; building external debt-management capacities; and improving the efficiency of the fiscal structure and the regulation of public services, through such means as a pricing mechanism for oil products and water and electricity tariffs.
- Compliance was commendable; only two waivers were requested and granted throughout the arrangement.

Under the PSI

- The PSI in the first year covers measures to reduce fiscal risks, strengthen policy formulation and control, streamline tax incentives, and improve budget prioritization; and measures to strengthen financial sector regulation.

World Bank Conditionality

- Bank conditions are spelled out for annual Poverty Reduction Support Credits (about US$10 million for 2006) under the Country Assistance Strategy approved in February 2005; the goals are to ensure macroeconomic stability, support private-sector-led growth, and alleviate poverty.
- The PRSCs are directed to reforms of public expenditure management, the civil service, and the judiciary; decentralization; human resource development; and improvements in the effectiveness and sustainability of the social protection system.

[4] The PRSP Progress Report and Joint Staff Advisory Note are being issued separately to the Board.

A. Accelerating Growth and Reducing Poverty

17. **The new government's economic strategy for 2006–11 aims at substantially increasing GDP growth over the medium to long term to support significant reductions in unemployment and poverty.** Staff agreed that Cape Verde's growth prospects seem favorable, despite higher oil prices and the country's limited natural resources. Strong foreign interest and investment in tourism-related activities, coupled with continued public investment in infrastructure, provide a solid base for accelerating growth and reducing poverty. There was full agreement on the need to maintain stable and credible macroeconomic policies—as emphasized in the program to be supported under the PSI—to help ensure a continuing favorable environment for investment growth and, more generally, for economic and social development.

18. **Recognizing that there is not necessarily a direct link between tourism-related investment and stronger economic growth, the staff and authorities considered the policy priorities for ensuring that the benefits of tourism development spread into broad-based growth of domestic incomes and employment.** It was agreed that improvements in domestic capacities were crucial, supported in many cases by stronger regulatory frameworks. Priorities (often inter-related) are to:

- ***Improve the development and deployment of labor resources***. As part of the general strategy for human capital development elaborated in Cape Verde's PRSP, the authorities are working to enhance vocational training—including training targeted to tourism-related industries. While safeguarding working conditions, the government is also planning to amend the labor code to enhance the economy's flexibility and capacity to create jobs.

- ***Strengthen the business climate.*** One aspect of this is to support the development of small and medium-enterprises, including those that could provide ancillary services to the main tourism-related development. Besides its reforms in the labor market and financial sector, the government is reducing the administrative costs of doing business. "One-stop" facilities now being set up will make it possible to complete online all administrative procedures for registering and opening a business within 24 hours. Business development will also be supported by regulatory reforms the authorities are undertaking to liberalize the telecom market and develop transportation services.

- ***Support financial sector development.*** The authorities are endeavoring to identify and remove obstacles to private sector credit growth and reduce the cost of capital. These efforts include amending the regulatory and legislative framework to protect lenders, strengthening banks' capacity to provide project-based lending, and supporting access to credit for small and medium-sized enterprises. They also see development of the offshore financial sector as a means of expanding financial services and expertise. Noting, however, the risks that can arise in the offshore sector, the authorities agreed with staff on the need for regulatory reforms to ensure that this development takes place within a sound institutional framework that is in line with international best practice (see below).

- ***Ensure adequate and reliable supplies of energy and water.*** Service quantity and quality has been uncertain, given the long-standing difficult relations between the government and Electra. The staff argued that improving the regulatory framework in the energy sector would help resolve these difficulties—through, for instance, full and transparent implementation of the automatic mechanism for adjusting electricity and water tariffs. In particular, application of this mechanism would help provide a more stable and predictable environment for much-needed investment to improve the volume and efficiency of energy supply. The staff supported the authorities' strategy of promoting conservation and alternative energy sources to reduce Cape Verde's dependence on oil imports.

B. Safeguarding the Exchange Rate Regime

19. **The fixed exchange rate has served Cape Verde well as an anchor for economic stability.** There are no indications of any misalignment of the exchange rate emerging: the real effective exchange rate has depreciated by more than 6 percent over the last three years, in line with changes in the terms of trade in goods (Figure 2); export growth in goods and tourism services is strong; and foreign direct investment is booming. To ensure that the country remains competitive despite natural cost disadvantages, the authorities view as essential the need to maintain macroeconomic stability and low inflation. They agreed with staff that wage growth, even with the temporarily higher "headline" inflation, needs to be kept in line with productivity growth and underlying inflation. They also agreed that competitiveness and growth need to be supported by increased labor flexibility and productivity, trade liberalization, and development of higher-priced niche products in tourism.

20. **While the longer-term possibility of hardening the peg has been considered, the authorities saw no current need to move in this direction.** In their view, the main benefit from hardening the peg would be to increase the pressure for further improvements in fiscal discipline, thereby enhancing investor confidence. However, current policies are already headed in this direction and are supporting further increases in foreign reserves.

21. **Current foreign reserve coverage may be adequate to meet routine economic shocks and uncertainties, but the authorities would like to increase reserves further to better buffer against shocks.** Supporting this objective, the staff noted that further liberalization of the capital account would also require an increase in reserves (see Box 3). The new government program envisages an increase in reserve coverage by 2011 to about 4 months of current-year imports of goods and services. Such an outcome would bring reserves closer to the level of the monetary base, which would in principle allow the monetary system to be converted into a currency board at any time.

Box 3. Assessing the Adequacy of International Reserves

Assessing the adequacy of a country's international reserves requires judgments based on multiple indicators and country specific factors. The main indicators to consider are:

- **Import coverage:** Coverage of three or four months of prospective imports was in the past judged sufficient. It should be larger if official and private capital flows are large or volatile.
- **Short-term debt coverage:** Reserves should cover at least the country's one-year foreign liabilities (on a remaining maturity basis, and both domestic and foreign currency-denominated).
- **Base money coverage:** Reserves at least as high as the monetary base would in principle allow the system to be converted into a currency board at any time.

Country-specific factors for Cape Verde that support the case for further buildup of reserves are:

- The high dependence on capital inflows: official aid inflows are about 10–13 percent of GDP, remittances and other private transfers about 20 percent of GDP, and increases in emigrant deposits about 3–5 percent of GDP.
- The large stock of emigrant deposits—around 30 percent of GDP and 40 percent of broad money—with unknown interest rate sensitivity.
- A history of high volatility and periods of precariously low reserve coverage.
- Currently high excess reserves in the banking system.

Country-specific factors that mitigate the need for further reserve accumulation are:

- A Portuguese exchange rate support credit line of 27.5 million euros, with extension up to 45 million euros if Cape Verde provides collateral.
- The existence of capital account restrictions.
- A likely high correlation between foreign exchange inflows and outflows (e.g., through aid-funded imports for infrastructure projects, imports for tourists, goods for processing, and imports of goods for procurement in ports).

Main International Reserve Indicators for Cape Verde	2000	2004	2005
Gross reserve coverage in months of prospective imports	0.9	2.4	3.0
Less excess reserves	0.9	2.3	2.7
including the Portuguese credit line	2.3	3.4	3.9
Gross international reserves to currency in circulation	0.5	1.7	2.1
Gross international reserves to reserve money	0.2	0.6	0.8
including the Portuguese credit line	0.6	0.9	1.0
Gross international reserves to domestic broad money	0.1	0.3	0.4
Gross international reserves to emigrant and foreign currency deposits	0.2	0.4	0.5
Gross international reserves in millions of euros	30.4	102.4	147.5

Sources: Bank of Cape Verde, and staff estimates.

C. Managing Fiscal Pressures and Risks

22. **While the authorities have made substantial progress with fiscal consolidation in recent years, improving both expenditure prioritization and revenue collection, further efforts are needed to prepare for potential pressures on the budget.** For example, fiscal pressures may arise from:

- government liabilities to the public pension system as this develops and matures;
- growth in demand for health, education, training, and other public services;
- less access to highly concessional external support as Cape Verde moves into middle-income status; and
- associated with the last point, the prospective need for increased domestic capital participation in public investment projects.

23. **The authorities and staff agreed that medium-term fiscal policy should be oriented toward the creation of fiscal space to prepare for these and other contingencies.** Such space (see below) would be generated in part by reducing government debt as a share of GDP, which would both lower interest expenditures and provide an additional buffer against economic shocks.

D. Strengthening Public Sector Management

24. **The authorities are pursuing a number of structural reforms to strengthen the country's fiscal position.** These include measures to strengthen capacities and procedures for formulating, executing, monitoring, and auditing the budget. Implementing the Country Financial Accountability Assessment (CFAA) action plan and the medium-term expenditure framework (MTEF) will help. As mentioned, reforms are also under way to improve civil service capacities and productivity within the constraints of the wage bill. Departmental staffing levels are to be rationalized and wage structures reformed to ensure that government compensation is competitive without putting pressure on private sector wages.

V. Policy Discussions: The Medium-Term Policy Framework

25. **Drawing on the discussion of medium-term prospects and challenges, the authorities and staff reached understanding *ad referendum* on a three-year policy framework that could be supported by the PSI.** Details of the proposed program are set out in the attached MEFP. The economic and policy considerations underlying the program include:

- projections for economic growth and inflation for 2006–09;
- the rate of increase in foreign exchange coverage;
- the relative role of fiscal and monetary policy in supporting the reserve buildup and, associated with this;
- the formulation of the fiscal anchor and medium-term fiscal strategy;

- the design of the monetary policy operational framework; and
- structural measures to support fiscal objectives, reduce economic and financial risks, and enhance growth.

A. The Macroeconomic Framework

26. **The government's macroeconomic framework that would be supported under the PSI assumes a moderate pick-up in GDP growth after 2006, led by stronger investment.** Growth is projected to be around 5.5 percent in 2006, mainly because of short-term influences: these include the negative impact on private sector purchasing power of recent increases in food and regulated prices, and delays in undertaking the 2006 public investment program. Growth is expected to increase thereafter, however, averaging 6–7 percent in 2007–09. Foreign direct investment (FDI) is expected to remain strong, although cautiously assumed to grow at a more measured pace over the medium term; budget grants and loan assumptions are based on identified donor commitments; and the current levels of project assistance (apart from MCA-related activity) and private remittances as a share of GDP are assumed to continue over the medium term before gradually tapering off as residents' income level rises. There is also upside potential in the growth outlook—for example, if FDI continues to increase at the same rate as is projected for 2006 to 2007 (which is based on firm investment intentions).

Cape Verde: Key Projections, 2006–09
(Percent of GDP, unless otherwise specified)

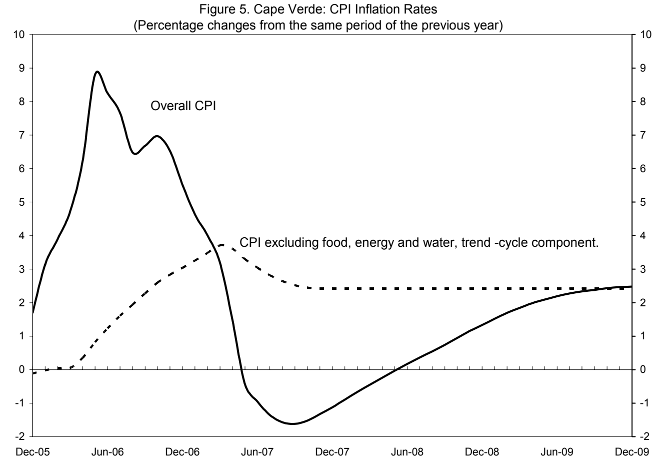
	2005	2006	2007	2008	2009
	Actuals	Projections			
Real GDP (percent change)	5.8	5.5	6.0	6.3	6.6
Inflation (annual, percent)	0.4	6.2	0.2	0.3	2.1
Central gov't revenues	24.1	25.1	24.7	25.2	25.8
Central gov't grants	7.1	9.0	8.9	9.2	9.3
Central gov't expenditures	36.3	41.2	37.9	38.4	38.0
Central gov't overall balance	-5.1	-7.1	-4.3	-4.0	-2.9
Central gov't domestic borrowing[1]	-0.2	-1.9	-0.2	-0.3	-0.5
Central gov't external borrowing[1]	3.2	3.5	3.4	3.3	2.4
Current account balance	-4.6	-6.9	-10.0	-11.0	-11.5
FDI	2.0	2.1	3.4	4.0	4.4
Investment ratio (percent)	37.9	38.7	41.2	43.8	45.0
Saving ratio (percent)	33.3	31.8	31.3	32.8	33.5
Broad money growth (percent, eop)	15.5	13.6	7.4	7.7	9.5

Sources: Cape Verdean authorities, and staff estimates.

[1] Excluding for arrears clearance.

27. **Consumer price inflation is projected to fall to close to zero in 2007–08 and stabilize at 2–3 percent thereafter.** The staff emphasized that a rapid return to low inflation will be important for supporting the exchange rate peg and allowing budget limits, particularly with regard to the wage bill, to be respected. In the projected scenario, the 12-month inflation rate would fall sharply once the recent increases in regulated prices fall out of the base and food prices return to more normal levels, as was the case in past episodes

Figure 5. Cape Verde: CPI Inflation Rates
(Percentage changes from the same period of the previous year)



Sources: Cape Verdean authorities, and staff projections.

of temporary shortfalls in supply of fish and fresh fruits and vegetables (Figure 5). Medium- to long-term inflation would then remain in line with inflation in the euro area. After declining in 2005, the current account deficit is projected to rise—largely reflecting higher imports of capital goods driven by MCA projects and private investment.

28. **The medium-term program aims to increase reserve coverage further, by 0.1 months of prospective imports per year** (equivalent to about ½ percent of GDP). In the authorities' view, which the staff shares, this goal should balance the need for strengthening reserve coverage against monetary and fiscal constraints, along with the desirability of keeping lending rates low to support credit expansion and private sector growth.

29. **Fiscal restraint will be necessary to reach the reserve target, as there is only limited scope for monetary policy to effect a long-term, sustainable buildup in reserves.** The fixed exchange rate regime implies that the domestic interest rate spread over the euro area must ultimately reflect the market risk premium and transaction costs. Moreover, containing *domestically financed* government expenditures would be the prime policy tool for achieving the reserve target. This arises because the overall fiscal deficit largely reflects the provision of external aid and its grant-loan distribution, and the demand for foreign exchange from imports induced by aid-financed expenditures is broadly matched by aid inflows.

30. **Containing government domestic borrowing, moreover, will help the government reach its objective of lowering public debt.** The program aims to lower the central government debt ratio to below 70 percent of GDP by 2009. This includes reducing government domestic debt to close to 20 percent of GDP by 2009, down from around 33 percent at end-2005. Anchored on this medium-term target for domestic debt, net domestic borrowing would be the operational target and assessment criterion under the PSI; borrowing would be measured exclusive of arrears clearance, to support the rapid elimination of arrears.[5]

31. **The targeted debt reduction is consistent with further growth of capital spending and high-priority current spending.** Moreover, the program would create significant fiscal space—growing to around 1.7 percent of GDP by 2009—for additional priority spending, tax cuts, or further debt reduction. This fiscal space is created through:

- mobilizing domestic revenue as recent improvements in the tax system and tax administration take hold and efforts to streamline tax incentives and exemptions bear fruit;
- improving expenditure prioritization in line with the PRSP;
- moderately scaling back the wage bill as a share of GDP to its 2005 level;
- ending petroleum subsidies, as announced in the 2006 budget; and

[5] This approach also ensures that the borrowing target is consistent with the definition of domestic debt, which is measured net of deposits but including arrears.

- lowering interest costs as debt declines.

32. **The program allows for a limited amount of well-targeted government or government-guaranteed external borrowing that does not meet the full 35 percent concessionality threshold,** if fully concessional financing of essential projects is not available. The US$20 million cap on less concessional borrowing is in line with the PRGF arrangement, where this provision enabled the government to borrow on terms that fell short of the 35 percent threshold. This borrowing was used to finance important health, education, and infrastructure projects, including the new international airport in Praia. Cape Verde's long-term debt sustainability (see Appendix II) would not be jeopardized if highly concessional loans are below the baseline assumptions and the resulting gap is covered by a limited amount of less concessional borrowing.[6]

33. **As in the past, medium-term monetary policy will be geared to safeguarding the exchange rate peg with the euro as an anchor for low inflation.** Consistent with this, the monetary policy framework has at times functioned similarly to a currency board: changes in the foreign reserves at the central bank have been the main source of variations in the money supply and, at least until recently, the BCV has been fairly passive in using the limited monetary policy instruments at its disposal to control liquidity. Fiscal dominance is absent; the government is required by law to settle any outstanding balance on its overdraft account in the BCV at the end of each year.

34. **Nevertheless, periodic upsurges in excess liquidity in the banking system and the recent decline in Treasury bill rates have highlighted some uncertainties in the BCV's monetary policy operating framework—**including how the Bank should respond to such developments. Following recent technical assistance from the IMF, the authorities felt that there was a need for, and sufficient capital account frictions to allow, somewhat more active liquidity management to prevent destabilizing swings in liquidity and interest rates. Drawing on that technical assistance, the authorities intend to formulate a set of intermediate monetary indicators—including broad money, credit growth, excess liquidity, and the interest differential with the euro area—to guide liquidity management and other dimensions of policy conduct. In-house capacity for tracking large external capital flows will be built, in part to gauge the interest sensitivity of emigrant deposits and other private flows.

B. The Structural Reform Program

35. **Enhanced structural reforms will be crucial to achieving the PSI's objectives.** Authorities and staff agreed that reform priorities are improving economic governance, fiscal management, and capacity to formulate policy; sheltering the budget from quasi-fiscal losses; and strengthening the financial sector. The reform agenda the MEFP details includes:

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[6] The alternative scenario elaborated in the DSA indicates that the country's external sustainability ratios would continue to imply a low probability of debt distress even if the US$20 million per year limit under the program were borrowed on fully commercial terms. However, the ratio of debt service to exports would increase by 3 percentage points by 2009 and 4 percentage points by 2026.

- Clearance of the stock of outstanding central government arrears of CVEsc 5.3 billion by end 2009 (as scheduled in Appendix I, Table 1) and measures to prevent arrears from again accumulating.
- Further efforts to reinforce revenue collection. The government intends to submit legislation to the National Assembly by mid-2007 that would reform the complex system of tax exemptions; in particular, exemptions will be granted only according to clearly defined economic criteria that correspond to the national development strategy, and will be regulated under a single law.
- Measures to strengthen public sector management capacity, including implementation of the CFAA action plan and the MTEF and the new impetus to reforming civil service staffing and compensation arrangements.
- Regulatory and institutional reforms to support production and distribution of electricity and water, including full application of the automatic tariff adjustment mechanism.
- Reforms to ensure that the regulation and supervision of financial institutions, including in the offshore center, are in line with international best practice. These measures will draw on the conclusions of a task force organized by the BCV.

VI. PROGRAM FOR 2006–07

36. **The government's program for 2006–07 as spelled out in the MEFP is in line with the medium-term strategy discussed above.** By frontloading implementation of key measures, the 2006 budget takes important steps toward supporting the government's medium-term macroeconomic strategy. Some highlights of the short-term fiscal strategy:

- The fiscal position will be strengthened, supported by privatization and land sale receipts (3.7 percent of GDP). To continue to reduce domestic debt, government net domestic borrowing—except for clearance of arrears and late payments—will be limited to -1.9 percent of GDP in 2006 and -0.2 percent in 2007. As a result, domestic debt, net of deposits but including arrears, is projected to decline to 25 percent of GDP at end-2007.
- Arrears clearance of 1.7 percent of GDP is budgeted for 2006 (one-third of the end-2005 stock of arrears) and significant further arrears clearance is anticipated in 2007.
- Petroleum subsidies were eliminated starting June 1, 2006, and full provision has been made in the 2006 budget for oil subsidies accrued in 2005 and the first part of 2006 (in the past, these subsidies were paid with a one-year lag).

37. **The program will be monitored using the assessment criteria and structural benchmarks set out in the tables and in the Technical Memorandum of Understanding attached to the MEFP** (see also paragraph 29 of the MEFP). Program implementation and the economic results associated with the program will be subject to two reviews per annum. The program initially establishes quantitative and structural assessment criteria and benchmarks for end-September 2006 and end-December 2006, and indicative targets for

2007.[7] The first review mission, scheduled for November 2006, would reach understandings on assessment criteria and structural benchmarks for 2007.

VII. Risks to the Program

38. **As a small open economy with a narrow export base, Cape Verde is susceptible to external and domestic shocks.** For example, a deterioration in international security could reduce tourism flows or investments; and increases in refugee inflows, as have occurred recently, could put pressure on social services and the fiscal situation. Specific risks that are related more directly to program assumptions include:

- **Higher than expected inflation:** this could occur, for example, if wage growth in 2006–07 exceeds underlying inflation and productivity growth. An encouraging sign that economy-wide wage movements will be moderate despite increases in food and regulated prices is the recently announced 3.5 percent increase in civil service wages.

- **Continued increases in the government wage bill:** failure to scale back the wage bill to its 2005 level (as a share of GDP) would cut the 2007 fiscal space in half, while a continuation of the wage bill growth experienced over the last five years would eliminate the projected fiscal space entirely and leave a residual financing gap of 1 percent of GDP by 2009.

- **Quasi fiscal risks and service disruptions among public service enterprises:** such concerns could arise if there was failure to reach agreement on the investment plan for Electra, or if economic or political obstacles did not allow TACV to operate on fully commercial terms.

- **Outflows of emigrant deposits:** there is still substantial uncertainty about what motivates emigrant deposits, which comprise around 40 percent of M2. In particular, it is unclear how sensitive these deposits would be to further reductions in the interest rate differential between Cape Verde and more advanced economies (particularly the European Union and the United States) where most of the Cape Verde diaspora resides. Gross international reserves would be reduced to less than 2 months of imports if only 20 percent of the emigrant deposits were withdrawn, and completely depleted with a withdrawal of less than 60 percent.

- **Fluctuations in external concessional support:** Cape Verde's ability to reduce domestic debt as projected under the program would be impaired if there were temporary shortfalls in external grants or highly concessional loans (or if this support fell away more rapidly than expected with the country's move to middle-income status), and if resulting financing gaps were met using domestic resources.

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[7] The relatively close interval between the first two reviews and associated test dates is designed to enable the program to begin without delay, but then to move quickly to a review cycle aligned with the fiscal year—involving end-June and end-December test dates.

VIII. Statistical Issues and Technical Assistance Needs

39. **The quality and timeliness of Cape Verde's economic and financial data are generally adequate for surveillance and program monitoring, although some areas need substantial improvement** (see Appendix III). The staff expressed concerns about the monitoring of some aspects of fiscal performance and debt (especially external debt), weaknesses in the national accounts and CPI, and tracking of large external flows. The authorities are working to strengthen statistics. A comprehensive master plan directed by the National Statistical Institute (INE) outlines the steps needed for improving all areas of statistics. Cape Verde's development partners have already committed a substantial part of the estimated US$15 million required to implement the plan through 2010. The authorities are also making progress in revising the national accounts and a new CPI index is scheduled to be released in 2006. Staff stressed the importance of adequately funding full implementation of these improvements.

40. **The authorities are seeking continued technical assistance,** not only for strengthening the statistical system but also for improving debt management, producing summary fiscal information from the online budget monitoring system, and strengthening regulation of the financial sector.

IX. Staff Appraisal

41. **The authorities are firmly committed to macroeconomic stability and structural reforms.** Their policies are strengthening the foundations for sustained growth and poverty reduction. Cape Verde's strong economic performance under its first PRGF-supported program, supported by official and private capital inflows, has significantly alleviated poverty and led to Cape Verde's "graduation" (effective in 2008) to middle-income status. Growth reached close to 6 percent in 2005, and the fiscal stance was prudent through the recent election cycle—contributing to a further build-up of international reserves, a decline in domestic debt, and enhanced policy credibility.

42. **Cape Verde's medium-term outlook is favorable despite the impact of higher international oil prices on current economic activity.** After slowing in 2006, growth is expected to increase in the years ahead. The recent sharp increase in inflation is expected to subside in 2007, but vigilance is required to ensure that one-off price adjustments do not spread into more generalized inflation. Economic prospects are still largely driven by tourism. A narrow economic base, capacity constraints, and the natural cost disadvantages of a small country spread across many islands keep Cape Verde susceptible to such external and domestic shocks as a deterioration in international security or the investment environment or, on the domestic front, quasi-fiscal risks and service disruptions in public service enterprises.

43. **The fixed exchange rate has served Cape Verde well as an anchor for economic stability.** The peg to the euro should continue to play the central role in the macroeconomic policy framework. There is no current need to harden the peg further, although this could be considered as a longer-term policy option.

44. **The government's medium-term program provides a sound basis for macroeconomic stability, economic development, and poverty reduction.** The program gives particular attention to reducing fiscal risks and allowing Cape Verde a margin of safety to help protect the economy against shocks. The structural reform program appropriately centers on strengthening economic management through building capacity in fiscal management and policy formulation; sheltering the budget from quasi-fiscal losses; and strengthening the financial sector.

45. **To provide a firmer buffer against economic shocks, the government's medium-term macroeconomic framework is geared toward a further increase in international reserves and a reduction in the government debt-to-GDP ratio.** The staff fully agrees with these program anchors. Containing domestic borrowing should help achieve both objectives: the overall fiscal deficit largely reflects the provision of external aid and its grant/loan distribution, and there is only limited scope for monetary policy to effect a long-term, sustainable buildup in reserves. Fiscal restraint is also needed for creating space to meet potential future pressures on the budget, including from the public pension system and possible declines in highly concessional external support.

46. **The targeted rate of reserve build-up and debt reduction appropriately balances monetary and fiscal considerations.** In particular, the macroeconomic framework provides adequate room for lower interest rates, increased credit to the private sector, and further growth of government capital spending and high-priority current spending.

47. **The government's program for 2006–07 is in line with the medium-term strategy and frontloads key measures.** The fiscal position will be substantially strengthened through a sizable reduction in the domestic debt ratio; clearance of arrears and steps to prevent their recurrence; and full provision in the budget for past oil subsidies together with elimination of future petroleum subsidies, which will remove a key source of fiscal risk. However, debt reduction in 2006 is largely due to one-off privatization and land sale receipts, which cannot be relied on as financing sources in the future.

48. **The restructuring and privatization of the national airline TACV and the port operator ENAPOR should help reduce fiscal risks, improve economic efficiency, and enhance growth prospects.**

49. **Despite recent progress, ensuring adequate and reliable supplies of electricity and water remains a significant concern.** A key for overcoming current difficulties is to strengthen the regulatory framework so that tariff levels provide adequate incentives for investment. In particular, full and transparent application of the automatic tariff adjustment mechanism for electricity and water would help provide a more stable environment for much needed investment to improve the volume and efficiency of energy supply, and prevent the re-emergence of a tariff deficit.

50. **The rapidly developing offshore financial center needs to be carefully monitored.** While this sector may provide gains in employment, expertise, and financial services to the economy, there are also inherent risks. Regulatory reforms are necessary to ensure that

financial development takes place within a sound institutional framework that is in line with international best practice.

51. **Cape Verde's economic and financial data are generally adequate for surveillance and program monitoring, but weaknesses remain**. Efforts currently under way to address these weaknesses are welcome, and the staff urges the authorities to provide adequate budgetary resources to ensure full implementation of the statistical master plan.

52. **Given the authorities' clear and demonstrated commitment to sound economic management, the staff recommends Executive Board approval of the request for a three-year PSI.**

53. **It is recommended that the next Article IV consultation with Cape Verde take place within 24 months subject to the provisions of the decision on consultation cycles in program countries**.

Table 1. Cape Verde: Selected Economic and Financial Indicators, 2002–09

	2002	2003	2004	2005	2006	2007	2008	2009
					Projections			
			(Annual percentage change)					
National accounts and prices								
Real GDP	5.3	4.7	4.4	5.8	5.5	6.0	6.3	6.6
Real GDP per capita	3.4	2.8	2.5	3.8	3.5	4.1	4.3	4.6
Consumer price index (annual average)	1.9	1.2	-1.9	0.4	6.2	0.2	0.3	2.1
Consumer price index (end of period)	3.0	-2.3	-0.3	1.7	5.5	-1.1	1.3	2.5
External sector								
Exports of goods and services	14.1	6.1	5.2	20.5	8.9	4.8	6.1	6.2
Imports of goods and services	15.3	7.5	6.5	0.5	14.6	9.2	8.9	8.9
Real effective exchange rate (annual average)	0.5	1.8	-2.9	-2.1	...	...	...	...
Terms of trade (minus = deterioration)	-0.7	1.9	-2.8	-3.3	-0.5	1.4	1.3	0.9
Government budget								
Total revenue (excluding grants)	12.3	5.1	8.7	10.2	17.3	5.8	9.7	12.2
Total expenditure	13.4	-1.4	26.5	1.2	27.8	-1.2	9.1	8.3
Noncapital expenditure	6.2	8.6	-0.7	7.9	20.7	-3.8	9.5	6.7
Capital expenditure	27.8	-18.0	45.8	3.9	40.1	2.5	8.6	10.6
Money and credit								
Net foreign assets	18.6	-7.7	31.9	58.8	19.0	9.6	9.6	9.4
Net domestic assets	13.2	13.2	5.7	3.4	11.2	6.4	6.8	9.5
Of which: net claims on the central government	23.1	3.4	1.4	-4.3	6.9	-11.7	-15.2	-4.0
credit to the economy	12.0	15.2	9.3	9.2	13.7	13.9	13.8	12.9
Broad money (M2)	14.3	8.6	10.5	15.5	13.6	7.4	7.7	9.5
Domestic broad money (M2X)	10.3	4.2	8.8	17.3	15.4	7.4	7.7	9.5
Income velocity (GDP/M2)	1.48	1.46	1.37	1.29	1.27	1.23	1.23	1.24
				(Percent of GDP)				
Saving-investment balance								
Gross capital formation	35.8	31.0	36.8	37.9	38.7	41.2	43.8	45.0
Government	9.2	6.4	9.8	11.6	14.4	13.8	13.9	14.0
Nongovernment	26.7	24.7	27.0	26.3	24.2	27.5	29.9	30.9
Gross national savings	24.4	20.0	22.4	33.3	31.8	31.3	32.8	33.5
Of which: government	5.7	5.3	7.4	7.2	9.0	10.5	11.1	12.1
External current account (including official current transfers)	-11.4	-11.1	-14.4	-4.6	-6.9	-10.0	-11.0	-11.5
Government budget								
Total revenue	22.9	22.0	23.2	24.1	25.1	24.7	25.2	25.8
Total grants	8.7	5.5	10.9	7.1	9.0	8.9	9.2	9.3
Total expenditure	34.4	31.1	38.1	36.3	41.2	37.9	38.4	38.0
Overall balance before grants	-11.5	-9.1	-14.9	-12.2	-16.1	-13.2	-13.2	-12.2
Overall balance (including grants)	-2.9	-3.5	-4.0	-5.1	-7.1	-4.3	-4.0	-2.9
External financing (net)	-1.3	1.8	0.9	3.2	3.5	3.4	3.3	2.4
Domestic financing (net)	6.5	2.0	3.8	1.7	3.6	0.9	0.7	0.5
Financing gap/ statistical discrepancy	-2.3	-0.3	-0.7	0.2	0.0	0.0	0.0	0.0
Total nominal government debt [1]	85.7	84.8	89.0	88.1	79.6	77.1	74.3	69.8
External government debt [2]	56.4	57.5	54.0	55.4	52.4	52.0	51.4	49.3
Domestic government debt, net of deposits [3]	29.2	27.3	35.0	32.7	27.2	25.1	23.0	20.5
External current account (excluding official current transfers)	-17.2	-17.1	-20.1	-9.3	-14.4	-16.4	-17.3	-17.7
Overall balance of payments	6.3	-0.7	4.1	5.7	2.2	2.2	2.4	1.9
External current account (million euros, including official transfers)	-75.5	-79.7	-107.0	-36.1	-61.0	-95.2	-113.0	-129.3
Gross international reserves (million euros, end of period)	76.1	74.1	102.4	147.4	166.4	187.1	210.1	233.0
Gross international reserves (months of prospective imports of goods and services)	1.9	1.7	2.4	3.0	3.1	3.2	3.3	3.4
External debt service (percent of exports of goods and services)	12.4	10.5	11.3	8.8	8.2	7.9	7.6	8.6
Memorandum items:								
Nominal GDP (billions of Cape Verde escudos)	72.8	79.5	82.1	87.2	98.1	105.4	113.6	124.3
GDP per capita (millions of current U.S. dollars)	105.1	87.3	81.0	93.5	…	…	…	…
Exchange rate (Cape Verde escudos per U.S. dollar)								
Period average	117.2	97.7	88.8	88.7	…			
End period	105.1	87.3	81.0	93.5	…			

Sources: Cape Verdean authorities, and staff estimates and projections.

[1] Net of central government deposits; including verified stock of domestic and external arrears.

[2] Measured in domestic currency. The increase in the ratio from 2004 to 2005 is due to the appreciation of the dollar in 2005.

[3] Excluding the claims on the offshore Trust Fund.

Table 2. Cape Verde: Annual Fiscal Operations of the Central Government, 2005–09

	2005	2006			2007	2008	2009
	Prel.	Program [1]	Budget			Proj	
				Of which arrears			
	(Billions of Cape Verde escudos, unless otherwise indicated)						
Revenue, grants, and net lending	27.183	33.437	31.612		35.422	38.977	43.614
Domestic revenue	20.976	24.604	24.604		26.037	28.563	32.042
Tax revenue	18.601	21.099	21.099		23.050	25.228	28.310
Income and profit taxes	5.822	6.955	6.955		7.368	8.084	9.092
Personal income tax	3.516	3.727	3.727		4.450	4.883	5.491
Corporate income tax	2.306	3.228	3.228		2.918	3.202	3.601
Consumption taxes	7.390	8.351	8.351		9.352	10.262	11.541
Taxes on goods and services	0.838	0.989	0.989		1.061	1.164	1.309
Value-added tax	6.552	7.363	7.363		8.291	9.098	10.232
International trade taxes	4.231	4.501	4.501		4.865	5.274	5.869
Other taxes	1.158	1.291	1.291		1.465	1.608	1.808
Nontax revenue	2.375	3.505	3.505		2.986	3.336	3.732
Of which: Profit transfers	0.034	0.559	0.559		0.034	0.100	0.100
External grants	6.208	8.833	7.009		9.386	10.413	11.572
Capital grants	5.657	7.003	7.003		8.559	9.697	10.836
Of which: MCI	0.665	0.333			1.386	2.001	2.460
Budget support	0.551	1.830	0.006		0.827	0.717	0.736
Total expenditure	31.615	40.413	40.413		39.913	43.558	47.191
Recurrent expenditure	18.266	22.416	24.123	1.708	21.171	22.410	23.876
Primary recurrent expenditure	16.337	20.593	22.301		19.283	20.395	21.734
Wages and salaries	10.733	12.712	12.712		13.251	14.016	15.188
Goods and services	1.157	1.862	1.862		2.016	2.183	2.430
Transfers and subsidies	3.149	5.146	6.575		3.088	3.207	3.025
Transfers	2.616	3.921	3.921	0.000	3.058	3.180	2.998
Subsidies	0.533	1.225	2.653	1.429	0.030	0.027	0.026
Of which: petrol price subsidies	0.450	1.200	2.400	1.200	0.000	0.000	0.000
Other expenditures	1.298	0.873	1.152	0.279	0.928	0.989	1.091
Domestic interest payments	1.384	1.300	1.300		1.227	1.264	1.293
External interest payments	0.546	0.522	0.522		0.661	0.751	0.849
Capital expenditure	11.624	16.290	16.290		16.705	18.147	20.073
Foreign- financed	9.755	12.534	12.534		13.522	14.711	15.812
Domestically financed	1.869	3.755	3.755		3.182	3.436	4.261
Unspecified expenditures (fiscal space)					0.847	1.811	2.052
Accrual of accounts payable (late payments or *atrasados)*	0.944						
Arrears clearance	0.781	1.708			1.190	1.190	1.190
Overall balance, including grants (budget basis)	-4.432	-6.976	-8.801		-4.491	-4.582	-3.577
Financing (cash)	4.432	6.976	8.813		4.491	4.582	3.577
Foreign (net)	2.785	3.414	3.414		3.541	3.781	2.977
Total drawings	4.826	5.531	5.531		5.726	5.926	5.615
Amortization	-2.041	-2.117	-2.117		-2.185	-2.145	-2.639
Domestic financing (net)	1.464	3.575	5.399		0.950	0.800	0.600
Net domestic borrowing	1.209	0.830	2.655		0.950	0.800	0.600
Accrual of accounts payable (late payments or *atrasados)*	0.944	0.000	0.000				
Repayment of accounts payable (late payments or *atrasados)*	-1.506	-0.944	-0.944				
Privatization revenues	0.000	1.394	1.394		0.000	0.000	0.000
Other net sales of financial assets	0.523	0.000	0.000		0.000	0.000	0.000
Net sales of nonfinancial assets	0.294	2.295	2.295		0.000	0.000	0.000
Net errors and omissions	0.183	0.000	0.000		0.000	0.000	0.000
Memorandum items:							
Overall balance, including grants (excluding clearance of arrears and late payments)	-3.089	-4.324	-6.149		-3.301	-3.391	-2.387
Clearance of accounts payable (late payments or *atrasados*)	0.562	0.944	0.944		0.000	0.000	0.000
Arrears clearance (part of despesa extraordinaria and other)	0.781	1.708	1.708		1.190	1.190	1.190
Net domestic borrowing excluding for clearance of arrears and net late payments	-0.133	-1.821	0.003		-0.240	-0.390	-0.590
Primary balance, including grants [2]	-2.502	-5.154	-6.978		-2.603	-2.567	-1.435
Recurrent domestic balance [3]	2.709	2.188	2.188		4.866	6.154	8.166
Net external flows [4]	8.992	12.234	10.410		12.927	14.195	14.549
External debt service (percent of domestic revenue)	12.3	10.7	10.7		10.9	10.1	10.9
Domestic debt (including arrears and accounts payable, net of deposits)	28.517	26.696	28.520		26.455	26.065	25.474

Sources: Ministry of Finance and Public Administration, Bank of Cape Verde, and staff estimates and projections.

[1] Differ from the budget column in that budget grants firmly committed by the donors have been added, and the budgeted clearance of old arrears shown separately.

[2] Overall balance (including grants)- total expenditure + domestic and external interest payments.

[3] Domestic revenue - recurrent expenditure.

[4] External grants + net foreign financing.

Table 3. Cape Verde: Annual Fiscal Operations of the Central Government, 2005–09

(Percent of GDP)

	2005	2006		2007	2008	2009
	Prel.	Program [1]	Budget		Proj	
Revenue, grants, and net lending	31.2	34.1	32.2	33.6	34.3	35.1
Domestic revenue	24.1	25.1	25.1	24.7	25.2	25.8
Tax revenue	21.3	21.5	21.5	21.9	22.2	22.8
Income and profit taxes	6.7	7.1	7.1	7.0	7.1	7.3
Consumption taxes	8.5	8.5	8.5	8.9	9.0	9.3
Taxes on goods and services	1.0	1.0	1.0	1.0	1.0	1.1
Value-added tax	7.5	7.5	7.5	7.9	8.0	8.2
International trade taxes	4.9	4.6	4.6	4.6	4.6	4.7
Other taxes	1.3	1.3	1.3	1.4	1.4	1.5
Nontax revenue	2.7	3.6	3.6	2.8	2.9	3.0
Of which: Profit transfers	0.0	0.6	0.6	0.0	0.1	0.1
External grants	7.1	9.0	7.1	8.9	9.2	9.3
Capital grants	6.5	7.1	7.1	8.1	8.5	8.7
Of which: MCI	0.8	0.3	0.0	1.3	1.8	2.0
Budget support	0.6	1.9	0.0	0.8	0.6	0.6
	5.7	6.8	7.1	6.8	6.8	6.7
Total expenditure	36.3	41.2	41.2	37.9	38.4	38.0
Recurrent expenditure	21.0	22.8	24.6	20.1	19.7	19.2
Primary recurrent expenditure	18.7	21.0	22.7	18.3	18.0	17.5
Wages and salaries	12.3	13.0	13.0	12.6	12.3	12.2
Goods and services	1.3	1.9	1.9	1.9	1.9	2.0
Transfers and subsidies	3.6	5.2	6.7	2.9	2.8	2.4
Transfers	3.0	4.0	4.0	2.9	2.8	2.4
Subsidies	0.6	1.2	2.7	0.0	0.0	0.0
Of which: petrol price subsidies	0.5	1.2	2.4	0.0	0.0	0.0
Other expenditures	1.5	0.9	1.2	0.9	0.9	0.9
Domestic interest payments	1.6	1.3	1.3	1.2	1.1	1.0
External interest payments	0.6	0.5	0.5	0.6	0.7	0.7
Extraordinary expenditures	0.0	0.0	0.0	0.0	0.0	0.0
Capital expenditure	13.3	16.6	16.6	15.8	16.0	16.1
Foreign-financed	11.2	12.8	12.8	12.8	13.0	12.7
Domestically financed	2.1	3.8	3.8	3.0	3.0	3.4
Unspecified expenditures (fiscal space)				0.8	1.6	1.7
Accrual of accounts payable (late payments or atrasados)	1.1	0.0	0.0	0.0	0.0	0.0
Arrears clearance	0.9	1.7	0.0	1.1	1.0	1.0
Overall balance, including grants (budget basis)	-5.1	-7.1	-9.0	-4.3	-4.0	-2.9
Financing (cash)	5.1	7.1	9.0	4.3	4.0	2.9
Foreign (net)	3.2	3.5	3.5	3.4	3.3	2.4
Total drawings	5.5	5.6	5.6	5.4	5.2	4.5
Amortization	-2.3	-2.2	-2.2	-2.1	-1.9	-2.1
Domestic financing (net)	1.7	3.6	5.5	0.9	0.7	0.5
Net domestic borrowing	1.4	0.8	2.7	0.9	0.7	0.5
Accrual of accounts payable (late payments or *atrasados)*	1.1	0.0	0.0			
Repayment of accounts payable (late payments or *atrasados)*	-1.7	-1.0	-1.0			
Privatization revenues	0.0	1.4	1.4	0.0	0.0	0.0
Other net sales of financial assets	0.6	0.0	0.0	0.0	0.0	0.0
Net sales of nonfinancial assets	0.3	2.3	2.3	0.0	0.0	0.0
Memorandum items:						
Overall balance, including grants (excluding clearance of arrears and net late payments)	-3.5	-4.4	-6.3	-3.1	-3.0	-1.9
Clearance of accounts payable (late payments or atrasados)	0.6	1.0	1.0	0.0	0.0	0.0
Arrears clearance (part of despesa extraordinaria and other)	0.9	1.7	1.7	1.1	1.0	1.0
Domestic borrowing excluding for clearance of arrears and net late payments	-0.2	-1.9	0.0	-0.2	-0.3	-0.5
Primary balance (including grants) [2]	-2.9	-5.3	-7.1	-2.5	-2.3	-1.2
Recurrent domestic balance [3]	3.1	2.2	2.2	4.6	5.4	6.6
Net external flows [4]	10.3	12.5	10.6	12.3	12.5	11.7
Domestic debt (including arreras and accounts payable, net of deposist)	32.7	27.2	29.1	25.1	23.0	20.5

Sources: Ministry of Finance and Public Administration, Bank of Cape Verde, and staff estimates and projections.

[1] Differ from the budget column in that budget grants firmly committed by the donors have been added, and the budgeted clearance of old arrears shown separately.
[2] Overall balance (including grants) - total expenditure + domestic and external interest payments.
[3] Domestic revenue - recurrent expenditure.
[4] External grants + net foreign financing.

Table 4. Cape Verde: Monetary Survey, 2005–09

	2005 Mar.	2005 Dec.	2006 Dec.	2007 Dec.	2008 Dec.	2009 Dec.
			Proj.			
	(Millions of Cape Verde escudos, unless otherwise specified)					
Net foreign assets	14,904	21,889	26,056	28,555	31,307	34,257
Foreign assets	19,119	27,549	31,716	34,197	36,881	39,698
Of which: foreign reserves	12,070	16,260	18,356	20,639	23,177	25,702
Foreign liabilities	-4,215	-5,660	-5,660	-5,642	-5,574	-5,441
Net domestic assets	49,003	50,755	56,456	60,076	64,172	70,258
Net domestic credit	57,633	59,404	65,127	68,769	72,886	78,996
Net claims on general government	25,436	24,863	25,854	24,051	21,985	21,521
Claims on the Trust Fund (TCMFs)	11,038	11,038	11,038	11,038	11,038	11,038
Net claims on the central government	14,878	14,418	15,406	13,602	11,533	11,067
Credit to central government	18,014	20,044	21,033	19,228	17,160	16,693
Deposits of central government	-3,136	-5,626	-5,626	-5,626	-5,626	-5,626
Of which: project deposits	-678	-351	-277	-277	-277	-277
Net claims on local government	39	-24	-22	-19	-17	-15
Net claims on other government agencies (INPS)	-519	-569	-569	-569	-569	-569
Credit to the economy	32,197	34,541	39,273	44,718	50,901	57,475
Credit to public enterprises	381	476	497	519	542	566
Credit to private sector	31,784	34,040	38,751	44,173	50,334	56,882
Claims on nonbank financial institutions	33	26	26	26	26	26
Other items (net)	-8,630	-8,648	-8,671	-8,693	-8,715	-8,737
Broad money (M2)	63,907	72,644	82,511	88,631	95,479	104,515
Narrow money (M1)	23,958	28,719	32,620	35,040	37,747	41,319
Currency outside banks	6,183	7,634	8,464	8,873	9,346	10,022
Demand deposits	17,775	21,086	24,156	26,166	28,400	31,298
Quasimoney	37,190	40,566	46,076	49,493	53,317	58,364
Time deposits	35,648	38,390	43,605	46,839	50,458	55,233
Other quasimonetary deposits	1,542	2,176	2,471	2,655	2,860	3,130
Foreign currency deposits	2,759	3,359	3,815	4,098	4,414	4,832
		23,825	26,367	28,322	30,510	33,398
Memo item: Emigrant deposits		2,176	2,471	2,655	2,860	3,130
	(Change in percent of broad money 12 months earlier)					
Net foreign assets	6.4	12.9	5.7	3.0	3.1	3.1
Net domestic assets	3.8	2.7	7.8	4.4	4.6	6.4
Net domestic credit	4.7	3.3	7.9	4.4	4.6	6.4
Net claims on the central government	0.1	-1.0	1.4	-2.2	-2.3	-0.5
Credit to the economy	4.8	4.6	6.5	6.6	7.0	6.9
Credit to public enterprises	0.4	0.5	0.0	0.0	0.0	0.0
Credit to private sector	4.5	4.2	6.5	6.6	7.0	6.9
Other items (net)	-0.9	-0.7	0.0	0.0	0.0	0.0
Broad money		15.5	13.6	7.4	7.7	9.5
Narrow money		6.8	5.4	2.9	3.1	3.7
Currency outside banks		1.4	1.1	0.5	0.5	0.7
Demand deposits		5.4	4.2	2.4	2.5	3.0
Time and savings deposits		6.5	7.2	3.9	4.1	5.0
Foreign currency deposits		1.1	0.6	0.3	0.4	0.4
Selected monetary indicators						
Income velocity of money	...	1.29	1.27	1.23	1.23	1.24
Emigrant deposits	25,713	28,318	31,339	33,663	36,264	39,697
Excess reserves /total deposits (percent)	3.1	2.1	0.8	0.8	0.8	0.8
Money multiplier (M2/M0)	3.30	3.44	3.69	3.71	3.73	3.75
Credit to the economy (percentage change)	9.5	9.2	13.7	13.9	13.8	12.9

Sources: See Table 4 (concluded).

Continued

Table 4. Cape Verde: Monetary Survey, 2005–09 (continued)

	2005		2006	2007	2008	2008
	March	Dec.	Dec.			
		Proj.	Proj.			
	(Millions of Cape Verde escudos, unless otherwise specified)					
Bank of Cape Verde						
Net foreign assets	11,303	15,308	17,403	19,705	22,311	24,968
Of which: net international reserves	11,120	15,109	17,204	19,506	22,112	24,769
Foreign assets	12,312	16,523	18,618	20,901	23,439	25,964
Foreign liabilities	-1,009	-1,215	-1,215	-1,196	-1,128	-996
Net domestic assets	8,069	5,828	4,965	4,180	3,285	2,925
Net domestic credit	9,667	6,889	6,047	5,284	4,411	4,074
Trust Fund claims	4,605	4,605	4,605	4,605	4,605	4,605
Net claims on central government	3,847	1,093	1,093	1,093	1,093	1,093
Credit to central government	5,106	4,779	4,779	4,779	4,779	4,779
Deposits of central government	-1,259	-3,685	-3,685	-3,685	-3,685	-3,685
Of which: project accounts	-678	-351	-277	-277	-277	-277
Of which: foreign currency deposits	-503	-1,347	-1,347	-1,347	-1,347	-1,347
Claims on local government	0	0	0	0	0	0
Credit to the economy	1,179	1,163	1,163	1,163	1,163	1,163
Credit to public enterprises	61	54	54	54	54	54
Credit to private sector	1,100	1,094	1,094	1,094	1,094	1,094
Claims on nonbank financial institutions	19	15	15	15	15	15
Credit to commercial banks	36	27	-815	-1,577	-2,451	-2,788
Other items (net)	-1,598	-1,061	-1,082	-1,104	-1,126	-1,148
Reserve money (M0)	19,372	21,136	22,368	23,885	25,595	27,893
Currency outside banks	6,183	7,634	8,464	8,873	9,346	10,022
Cash in vaults	994	1,058	1,205	1,298	1,402	1,539
Deposits of commercial banks	12,183	12,443	12,697	13,712	14,845	16,331
Deposits of private sector	0	0	0	0	0	0
Deposits of other financial institutions	12	2	2	2	2	2
Gross international reserves (millions of euros)	109.5	147.4	166.4	187.1	210.1	233.0
Net international reserves (millions of euros)	100.8	137.0	156.0	176.8	200.5	224.6
Reserve money (12-month change in percent)	12.9	14.3	5.8	6.8	7.2	9.0

Sources: See Table 4 (concluded).

Continued

Table 4. Cape Verde: Monetary Survey, 2005–09 (concluded)

	2005		2006	2007	2008	2008
	March	Dec.		Dec.		
		Proj.		Proj.		
	(Millions of Cape Verde escudos, unless otherwise specified)					
Commercial banks						
Net foreign assets	3,601	6,581	8,652	8,850	8,997	9,289
Foreign assets	6,807	11,026	13,098	13,296	13,442	13,734
Foreign liabilities	-3,206	-4,445	-4,445	-4,445	-4,445	-4,445
Of which: Nonresident deposits	-2,346	-3,520	-3,766	-3,766	-3,691	-3,691
Net domestic assets	54,111	58,428	65,395	70,907	77,136	85,205
Net domestic credit	61,144	66,016	72,982	78,495	84,723	92,792
Net claims on general government	16,984	19,165	20,156	18,353	16,287	15,823
Trust Fund claims	6,433	6,433	6,433	6,433	6,433	6,433
Other government deposits (INPS)	-519	-569	-569	-569	-569	-569
Net claims on central government	11,032	13,324	14,313	12,508	10,440	9,974
Loans and overdrafts	8,091	9,657	10,365	8,266	5,827	4,869
Holding of government securities	4,817	5,609	5,889	6,183	6,554	7,046
Deposits of central government	-1,877	-1,941	-1,941	-1,941	-1,941	-1,941
Net claims on local government	39	-24	-22	-19	-17	-15
Claims on local government	204	232	236	241	246	251
Deposits of local government	-166	-256	-258	-261	-263	-266
Credit to the economy	31,018	33,378	38,110	43,554	49,738	56,311
Credit to public enterprises	321	422	443	465	488	513
Credit to private sector	30,684	32,945	37,656	43,079	49,239	55,788
Claims on nonbank financial institutions	13	11	11	11	11	11
Net claims on the Bank of Cape Verde	13,141	13,473	14,717	16,587	18,698	20,658
Total reserves	13,177	13,500	13,902	15,010	16,247	17,870
Vault cash	994	1,058	1,205	1,298	1,402	1,539
Deposits with central bank	12,183	12,443	12,697	13,712	14,845	16,331
Required reserves	10,388	11,052	12,117	13,088	14,171	15,592
Excess reserves	1,795	1,391	579	624	674	739
Credit to the Bank of Cape Verde	-36	-27	815	1,577	2,451	2,788
Other items (net)	-7,033	-7,587	-7,587	-7,587	-7,587	-7,587
Deposit liabilities to nonbank residents	57,713	65,009	74,047	79,758	86,132	94,494
Local currency deposits	54,954	61,650	70,232	75,660	81,718	89,661
Demand deposits	17,763	21,084	24,156	26,166	28,400	31,298
Of which: emigrant deposits	2,584	3,394	3,756	4,034	4,346	4,757
Quasi money	37,190	40,566	46,076	49,493	53,317	58,364
Time deposits	35,648	38,390	43,605	46,839	50,458	55,233
Of which: emigrant deposits	22,118	23,825	26,367	28,322	30,510	33,398
Other quasimonetary deposits	1,542	2,176	2,471	2,655	2,860	3,130
Foreign currency deposits	2,759	3,359	3,815	4,098	4,414	4,832
Of which: emigrant deposits	1,012	1,100	1,217	1,307	1,408	1,541
Memorandum items:						
Emigrant deposits (as ratio to total deposits)	0.40	0.39	0.38	0.38	0.38	0.38
Other deposits (as ratio to total deposits)	0.60	0.61	0.62	0.62	0.62	0.62
Composition of emigrant deposits	1.00	1.00	1.00	1.00	1.00	1.00
Local currency	0.96	0.96	0.96	0.96	0.96	0.96
Demand	0.10	0.12	0.12	0.12	0.12	0.12
Time	0.86	0.84	0.84	0.84	0.84	0.84
Foreign currency	0.04	0.04	0.04	0.04	0.04	0.04

Sources: Bank of Cape Verde, and staff estimates and projections.

Table 5. Cape Verde: Balance of Payments, 2005–09

(Millions of Cape Verde escudos, unless otherwise indicated)

	2005	2006	2007	2008	2009
	Prel.	Proj.			
Current account balance (including official transfers)	-3,980	-6,725	-10,499	-12,463	-14,260
Trade balance	-30,960	-37,178	-42,114	-46,683	-51,328
Exports, f.o.b.	7,891	8,862	8,566	8,833	9,180
Imports, f.o.b.	-38,851	-46,040	-50,681	-55,516	-60,508
Services (net)	5,149	5,782	6,322	6,707	6,798
Credit	23,668	25,513	27,468	29,399	31,428
Of which: tourism	9,566	10,327	11,128	11,922	12,757
Debit	-18,519	-19,731	-21,146	-22,692	-24,630
Income (net)	-2,966	-2,905	-2,829	-2,836	-2,950
Credit	1,649	2,167	2,371	2,576	2,864
Debit	-4,615	-5,073	-5,201	-5,413	-5,814
Government interest	-551	-713	-661	-751	-849
Interest by other sectors	-3,029	-3,587	-3,824	-3,928	-4,119
Income on direct investment and other income	-1,035	-773	-715	-734	-846
Current transfers (net)	24,797	27,577	28,123	30,349	33,219
Government	4,090	7,404	6,832	7,154	7,735
Other	20,706	20,173	21,291	23,195	25,484
Capital and financial account (net)	7,173	8,900	12,827	15,137	16,627
Capital transfers	1,821	1,420	2,554	3,259	3,837
Government	1,831	1,420	2,554	3,259	3,837
Of which: MCA	665	333	1,386	2,001	2,460
Other	200	0	0	0	3,837
Direct investment (net)	1,708	2,110	3,543	4,498	5,421
Portfolio investment	0	0	0	0	0
Government	1,880	3,431	3,541	3,781	2,977
Trust Fund	-200	0	0	0	0
Net official flows	2,080	3,431	3,541	3,781	2,977
Disbursements	4,314	5,531	5,726	5,926	5,615
Amortization	-2,234	-2,101	-2,185	-2,145	-2,639
Other	0	0	0	0	0
Other capital	1,763	1,939	3,189	3,600	4,393
Commercial banks	-2,696	-2,071	-198	-146	-292
Emigrant deposit flows	3,227	3,021	2,324	2,601	3,432
Commercial credit (net)	564	0	0	0	0
Other	669	989	1,063	1,145	1,253
Net errors and omissions	1,808	0	0	0	0
Overall balance	5,000	2,175	2,328	2,674	2,367
Financing	-5,000	-2,096	-2,283	-2,538	-2,525
Gross international reserves (– = accumulation)	-4,964	-2,096	-2,283	-2,538	-2,525
Of which: IMF (net)	380	0	-19	-68	-132
Exceptional financing	-36	0	0	0	0
Financing gap	0	-80	-45	-136	158
Memorandum items:					
Current account (including official transfers, percent of GDP)	-4.6	-6.9	-10.0	-11.0	-11.5
Current account (excluding official transfers, percent of GDP)	-9.3	-14.4	-16.4	-17.3	-17.7
Overall balance (percent of GDP)	5.7	2.2	2.2	2.4	1.9
Gross international reserves	16,260	18,356	20,639	23,177	25,702
In months of current year's import of goods and services	3.4	3.3	3.4	3.6	3.6
In months of next year's import of goods and services	3.0	3.1	3.2	3.3	3.4
External public debt	48,303	51,733	55,274	59,056	62,032
Including financing gap	48,303	51,463	54,958	58,404	61,337
External aid (grants and loans; percent of GDP)	11.7	14.6	14.3	14.4	13.8
Including financing gap	11.7	14.5	14.3	14.3	14.0

Sources: Bank of Cape Verde, and staff estimates and projections.

Table 6. Cape Verde: Financial Soundness Indicators of the Banking Sector, 2002–05

(End-year; percent unless otherwise indicated)

	2002	2003	2004	2005
Capital adequacy				
Regulatory capital to risk-weighted assets	15	13.8	13.3	12.1
Regulatory tier 1 capital to risk-weighted assets	16.5	15.2	14.6	13.4
Asset quality				
Nonperforming loans to total loans	7.4	7.4	7.2	6.3
Nonperforming loans net of provisions to capital	-7.9	-3.6	0.4	-2.5
Provisions to nonperforming loans	114.9	106.3	99.3	104.9
Earnings and profitability				
Return on assets (ROA)	1.1	1.1	0.7	0.5
Return on equity (ROE)	18.7	19.8	12.3	9.7
Interest margin to gross income	66.7	68.5	65.5	62.7
Noninterest expenses to gross income	56.6	57.4	57.6	61.2
Liquidity				
Liquid assets to total assets [1]	…	48.8	48.1	46.2
Liquid assets to short-term liabilities [1]	…	174.3	176.9	170.2
Additional indicators				
Government deposits over total deposits	…	3.5	3.2	4.1
Emigrant deposits over total deposits	…	42	43.2	41.5
Emigrant deposits over total assets	…	35.8	37	34.8
Demand deposits over total deposits	…	32.9	31.7	32.4
Total loans over total deposits	…	51.4	51.3	47.9
Personnel cost over cost of operations	…	51.6	50.4	52.1
Spread (90 day lending - time deposit rate)	…	9	9	8.5
Spread (emigrant deposits - euro area deposit rate)	…	4.8	4.7	3.2

Sources: Bank of Cape Verde, IFS, and staff estimates.

[1] Liquid assets include cash in vault and marketable securities. Short-term liabilities include demand deposits.

Table 7. Cape Verde: Millennium Development Goals

	1990	1995	2001	2002	2004	2015 Target
Goal 1. Eradicate extreme poverty and hunger.						
Target 1: Halve between 1990 and 2015, the proportion of people whose income is less than US$1 a day.						
1. Population below US$ 1 a day (percent)	...	...	...	...	...	...
2. Poverty gap ratio at US$ 1 a day (percent)	...	...	...	...	...	...
3. Share of income or consumption held by poorest 20 percent (percent)	...	...	...	...	...	...
3a. Percentage of poor, 2001–02	...	...	30.0	...	...	...
3b. Incidence of absolute poverty [1]	49.0 2/	...	...	37.0	...	25.0
Target 2: Halve, between 1990 and 2015, the proportion of people suffering hunger.						
4. Prevalence of child malnutrition (percent of children under 5)	...	13.5	...	...	...	6.8
5. Population below minimum level of dietary energy consumption (percent)	...	...	...	...	...	...
Goal 2. Achieve universal primary education.						
Target 3: Ensure that, by 2015, children will be able to complete a full course of primary schooling						
6. Net primary enrollment ratio (percent of relevant age group)	...	...	...	...	99.2	...
7. Percentage of cohort reaching grade 5	...	...	...	...	92.8	...
8. Youth literacy rate (percent age 15–24)	81.5	85.0	88.6	89.1	89.1	...
Goal 3. Promote gender equality and empower women.						
Target 4: Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education by 2015.						
9. Ratio of girls to boys in primary and secondary education (percent)	...	96.1	...	...	99.9	100.0
10. Ratio of young literate females to males (percent ages 15–24)	87.5	90.4	93.3	93.8	93.8	100.0
11. Share of women employed in the nonagricultural sector (percent)	39.1	...	...	...	...	...
12. Proportion of seats held by women in the national parliament (percent)	12.0	11.0	11.0	11.0	11.0	...
Goal 4. Reduce child mortality.						
Target 5: Reduce by two-thirds between 1990 and 2015, the under 5 mortality rate						
13. Under 5 mortality rate (per 1,000)	60.0	50.0	38.0	36.0	35.0	20.0
14. Infant mortality rate (per 1,000 live births)	45.0	37.0	29.0	30.0	26.0	...
15. Immunization against measles (percent of children under 12 months)	79.0	66.0	72.0	...	68.0	...
Goal 5. Improve maternal health.						
Target 6: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.						
16. Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	190.0	150.0	...	...	...
17. Proportion of births attended by skilled health personnel	...	54.0	88.5	...	...	...
Goal 6. Combat HIV/AIDS, malaria and other diseases.						
Target 7: Halt by 2015, and begin to reverse, the spread of HIV/AIDS.						
18. HIV prevalence among females (percent ages 15–24)	...	...	...	...	...	...
19. Contraceptive prevalence rate (percent of women ages 15-49)	...	...	52.9	...	...	...
20. Number of children orphaned by HIV/AIDS	...	...	...	...	...	...
Target 8: Halt by 2015, and begin to reverse, the incidence of malaria and other major diseases.						
23. Incidence of tuberculosis (per 100,000 people)	...	...	182.0	166.3	167.9	...
24. Tuberculosis cases detected under DOTS (percent)	...	...	42.0	...	...	...

Sources: See Table 7 (concluded)

continued

Table 7. Cape Verde: Millennium Development Goals (concluded)

	1990	1995	2001	2002	2004	2015 Target
Goal 7. Ensure environmental sustainability.						
Target 9: Integrate the principles of sustainable development into policies and programs. Reverse the loss of environmental resources.						
25. Forest area (percent of total land area)	8.7	...	21.1	...	...	...
26. Nationally protected areas (percent of total land area)	...	0.0	0.0	...	...	
27. GDP per unit of energy use (PPP $ per kg oil equivalent)	...	...	...	...	...	...
28. CO2 emissions (metric tons per capita)	0.2	0.3	0.3	...	...	...
Target 10: Halve by 2015 the proportion of people without access to safe drinking water.						
30. Access to improved water source (percent of population)	...	...	74.0	...	80.0	...
Target 11: Achieve by 2020 significant improvement for at least 100 million slum dwellers						
31. Access to improved sanitation (percent of population)	...	...	71.0	...	42.0	...
32. Access to secure tenure (percent of population)	...	...	...	...	...	...
Goal 8. Develop a global partnership for development.[3]						
Target 16: Develop and implement strategies for productive work for youth.						
45. Unemployment rate of population ages 15–24 (total)	...	...	...	...	...	...
Target 18: Make available new technologies, especially information and communications.						
47. Fixed line and mobile telephones (per 1,000 people)	...	...	21.5	171.0	272.6	...
48. Personal computers (per 1,000 people)	...	81.7	68.6	...	79.7	...

Sources: World Bank, and Fund staff estimates.

[1] Absolute poverty measures the number of people in 1988 and 2002 whose income is below the 1988 national poverty line, indexed for inflation.

[2] Data for 1988.

[3] Targets 12–15 and indicators 29, 33–44 are excluded because they cannot be measured on a country specific basis. These are related to official development, assistance, market access, and the HIPC initiative. Indicators 21 and 22 are not relevant for Cape Verde.

Table 8. Cape Verde: Proposed Work Program 2006–09

Mission Date	Purpose	Board Date
May 2006	Discussion of a PSI	End-July 2006
November 2006	First review against end-September 2006 assessment criteria	End-January 2007
February 2007	Second review against end-December 2006 assessment criteria	End-April 2007
August 2007	Third review against end-June 2007 assessment criteria	End-October 2007
February 2008	Fourth review against end-December 2007 assessment criteria	End-April 2008
August 2008	Fifth review against end-June 2008 assessment criteria	End-October 2008
February 2009	Sixth review against end-December 2008 assessment criteria	End-April 2009

APPENDIX I: CAPE VERDE—LETTER OF INTENT

July 11, 2006

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
700 19th Street N.W.
Washington D.C. 20431

Dear Mr. de Rato:

1. In July 2005, the government of Cape Verde completed its first arrangement with the IMF under the Poverty Reduction and Growth Facility (PRGF). Put in place against the backdrop of severe macroeconomic imbalances that Cape Verde faced in 2001, the PRGF-supported program emphasized a strengthening of the fiscal position, an increase in international reserves, and a wide range of structural reforms. Overall results under the program were considerably better than expected, as reflected in the significant improvements that Cape Verde has experienced in terms of macroeconomic performance, policy credibility, and external financial support.

2. Looking ahead, the government is seeking to maintain a close policy dialogue with the IMF under the Policy Support Instrument (PSI). The government believes that Cape Verde is well-suited to the PSI: macroeconomic stability has been achieved; financial resources from the Fund are not needed; but the PSI would support the government's ongoing efforts to strengthen policy performance and signal its commitment to sound policies to the international community.

3. The attached Memorandum of Economic and Financial Policies (MEFP) sets out the government's economic goals and policy framework for 2006–09, for which it requests support under the three-year PSI. Key elements of this program include a reduction in government debt, a further increase in international reserves, and structural reforms to improve public sector management, reduce fiscal risks, and strengthen the financial sector.

4. Under the three-year PSI, the government will keep the IMF regularly updated on economic and policy developments and will provide the data needed for adequate monitoring of the program—including in the context of the twice-yearly reviews. During the period of this Instrument, Cape Verde will consult with the IMF on the adoption of any measures that may be appropriate at the initiative of the government, or whenever the Managing Director of the IMF requests such a consultation.

5. We authorize the IMF to publish this letter and the attached MEFP and the related staff report.

Sincerely yours,

/s/

João Pinto Serra
Minister of Finance and Public Administration

APPENDIX I, ATTACHMENT I: CAPE VERDE—MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES OF THE GOVERNMENT FOR 2006–09

I. INTRODUCTION

1. This memorandum summarizes the government of Cape Verde's economic objectives and policy framework for 2006–09, for which the Government is seeking support from the International Monetary Fund under the Policy Support Instrument (PSI). The government believes that Cape Verde is well-suited to a PSI. The economy is stable; IMF financial resources are not needed; but the Government would like to maintain a close dialogue with the Fund—both to support the ongoing strengthening of economic and policy performance, and to signal to the international community the authorities' commitment to maintain sound economic policies. The policies described are consistent with Cape Verde's Poverty Reduction Strategy Paper (PRSP), which sets out the country's medium-term development priorities.

2. **The PSI program described in this memorandum builds on the strong results that Cape Verde achieved in its previous arrangement with the IMF under the Poverty Reduction and Growth Facility (PRGF) arrangement**, which ended in July 2005. The economic strategy under the PRGF arrangement emphasized the need for fiscal consolidation, involving both restraint in public spending and improvements in revenue performance, in order to correct the severe macroeconomic imbalances that emerged in 2000–01. The strengthening of the fiscal position since 2001 has supported a large build-up in international reserves and growth of overall policy credibility. Reflecting these improvements in the policy environment, Cape Verde has experienced sizable inflows of external finance for investment and development, solid growth averaging around 5 percent over 2001–05, low inflation, and a reduction in poverty.

3. **While recent economic performance has been strong, Cape Verde continues to face large development challenges.** Unemployment and poverty remain high despite recent progress; and improving infrastructure, public services, and other underpinnings of sustainable growth and poverty reduction across many small islands is inherently slow and costly. For example, reaching the Millennium Development Goals in areas such as health, education, and sanitation will place major pressures on public spending to strengthen infrastructure and the volume and quality of services. To address these and other challenges, Cape Verde will continue to rely heavily on external support. The government also notes with concern that, despite its strong record of governance and policy performance, Cape Verde has not been deemed eligible for external debt relief under recent multilateral initiatives. To help redress this apparent incongruity, the government calls on the international community to continue to support growth and development in Cape Verde over the long term through grants and highly concessional financial assistance.

II. Recent Economic Developments

4. **The Cape Verde economy continues to perform well.** Preliminary economic indicators point to a pick-up in growth in 2005 to an estimated rate of around 6 percent. Inflation averaged only 0.4 percent in 2005, but has increased recently—mainly as a result of higher food and petroleum prices. Supported by prudent fiscal performance in 2005, international reserve accumulation has been strong, reaching 3.0 months of prospective imports in December 2005. Commercial banks' excess reserves increased substantially in 2005, a result of strong capital inflows, a lowering of the reserve requirement, and a slowdown in private sector credit growth in the first part of the year. In response, the Bank of Cape Verde (BCV) has sold securities to partially absorb the increase in liquidity.

5. **The government has been moving forward with its structural reform agenda.** A new management team has been selected to restructure the national airline TACV in preparation for its privatization, and the bidding process is getting under way for privatization of the port operator ENAPOR. The authorities have completed a detailed action plan to build capacity in public finance management, and has established a civil servants database to support analysis of the current workforce and proposals for further civil service reform. Steps have been taken to clear the backlog of government accounts: the draft accounts for 1998–2003 have been completed and submitted to parliament for transmittal to the Court of Auditors (TdC). Provisional quarterly accounts for 2004 and 2005 have also been submitted to the parliament.

6. **Thanks to sound governance and good economic performance, Cape Verde is attracting significant international support, both official and private, for investment and development.** Cape Verde was one of the first countries to receive support from the Millennium Challenge Account (MCA) in 2005. The amount of US$110 million will be disbursed in the next five years to finance growth in the country's physical and human capacities. Cape Verde has been deemed eligible for further support from the MCA under a new category created for lower middle income countries. Private investment inflows, directed largely toward the construction sector and tourism, remain strong, as evidenced by a large increase in the rate of project approvals during 2005.

7. **Financial services continue to develop rapidly.** The banking sector's total assets have grown by 20 percent since end-2004 to reach over 90 percent of nominal GDP, with growth heavily concentrated in the construction sector. Emigrant deposits, accounting for over 40 percent of total deposits, continue to play a critical role in the banking sector. The profitability of the banking sector suffered significantly in 2005, owing to a tightening in interest spreads and the excess liquidity noted above, although prudential indicators remain sound. The rapidly developing offshore banking sector in Cape Verde now includes four operational offshore banks, with four other banks and two parabanking companies already licensed but not yet operational. Among recent developments in the financial sector is an ongoing project to create a centralized credit bureau that would help lenders assess the basic creditworthiness of borrowers, thus enhancing access to credit and the overall credit culture. The Cape Verde stock exchange (Bolsa de Valores de Cabo Verde) is seeing a revival in activity, including daily trading of government bills and a small number of corporates.

III. Medium-Term Objectives and Strategy

8. **The Government's medium-term objectives and strategy are set out in the PRSP and other national planning documents, and have been reiterated and elaborated recently in the Government Program for 2006–11.** This strategy is directed at boosting growth and reducing poverty through private sector-led development and diversification of economic activities. In support of these goals, the Government's policy priorities include (i) building human capacities through improving access to education, training, and health care; (ii) strengthening infrastructure and institutions, including to support service sector growth in areas such as tourism, financial services, and communications; and (iii) improving governance and the capacity of the public sector to implement policy reforms and program mandates.

9. **The program to be supported by the PSI aims to provide a consistent and coherent economic policy framework to underpin the Government's medium-term development objectives.** In particular, the program focuses on enhancing the sustainability of growth and development by maintaining a stable macroeconomic environment and moving forward with structural reforms, especially in areas that have systemic significance for the economy. Specific attention is given to reducing fiscal risks and to providing Cape Verde with an adequate safety margin to help protect the economy against exogenous shocks. The macroeconomic framework would also help prepare Cape Verde for the prospect that, as the level of GDP per capita continues to rise, the country's access to highly concessional external finance may diminish.

10. **Key policy measures in the program include:**

- increasing foreign exchange coverage to further strengthen the credibility and resilience of the exchange rate peg;
- decreasing the burden of domestic debt and clearing remaining domestic arrears;
- strengthening public finance management capacity, expenditure control, and revenue performance;
- pursuing structural reforms to reduce fiscal risks and support efficiency improvements in the economy;
- regulatory reforms to ensure that financial sector development takes place within a sound institutional framework.

Outlook for growth and inflation

11. **The government's goal is that, as the human and physical capacities of the Cape Verde economy continue to build, growth should move up to double digit levels.** Macroeconomic and structural policy measures addressed under the PSI program will help lay the groundwork for attaining this longer-term growth objective. While economic activity in 2006 will be affected by the impact of higher international oil prices, growth is expected to pick up in the years ahead and average 6–7 percent during the PSI program. Strong private

investment in the tourism sector and public investment in infrastructure, complemented by the ongoing development of domestic capacities, will continue to provide the key support for growth. Following an upward move in inflation over 2006–07, driven in part by sharp adjustments in regulated prices following increases in international oil prices, consumer inflation is expected to stabilize at 2–3 percent over the medium term in line with rates in the euro area.

Fiscal policy and structural reforms

12. The medium-term fiscal strategy will be geared towards preserving macroeconomic stability, reducing risks, and creating fiscal space to prepare for potential future pressures on the budget. For example, fiscal pressures may arise from government liabilities to the public pension system as this develops and matures; from growth in demand for other public services; from the possibility that Cape Verde's access to highly concessional external support may diminish as the country moves further into middle income status; and, associated with the last point, from the prospective need for increased domestic capital participation in public investment projects. To support its fiscal and macroeconomic objectives, the government intends to reach and then maintain a central government debt ratio of no more than 70 percent of GDP. This goal would be attained under the medium-term program to be supported by the PSI through further reductions in both domestic and external debt as a share of GDP. Furthermore, with external financing largely directed toward the public investment spending, which has a high import content, the government recognizes that ongoing restraint in current spending and domestic borrowing will play an important role in supporting the desired increase in international reserves as well as the debt reduction objective. Hence, in the medium-term program, government domestic debt would be targeted to reach around 20 percent of GDP by 2009 (from over 33 percent at end-2005). In the scenario set out in the statistical tables, this objective would be consistent with further growth of capital spending, with net domestic borrowing that is in tandem with the program to clear old arrears, and with the creation of increasing fiscal space to meet pressures such as those noted above.[1]

13. **This fiscal stance would allow external debt to be lowered from 56 percent of GDP in 2005 to 49 percent in 2009.** The deficit will be driven primarily by the availability of highly concessional external loans for financing the government's public investment program. If any external debt is contracted or guaranteed by the central government on terms falling below the 35 percent concessionality threshold (as set out in the attached Technical Memorandum of Understanding), the total of this new nonconcessional external debt and guarantees will be held to no more than US$20 million per year (around 2 percent of GDP). To ensure that this and other borrowing remain consistent with its debt sustainability objectives, the government is seeking assistance from its international partners to support the strengthening of both debt management practices and project appraisal capacities.

[1] The fiscal methodology used in the statistical tables follows that set out in the 2001 GFS Manual, which the government intends to fully adopt as rapidly as possible. The government requests technical assistance from the IMF in support of this change.

14. **In support of these fiscal objectives, the government will continue to contain nonpriority current expenditures, improve the mobilization of domestic revenues, and limit contingent and quasi-fiscal liabilities.** Within the constraints imposed by revenue availability, expenditures will be prioritized in line with the PRSP objectives. The government's recent decision to end all energy subsidies, announced as part of the 2006 budget, represents an important step toward reducing expenditure pressures, strengthening budget management, and creating fiscal space for higher priority spending—including well-targeted measures to support those in need. The expenditure restraint necessary to achieve government's overall fiscal goals will nevertheless allow a substantial increase in government investment, which is expected to remain around 16 percent of GDP over 2006–09, up from 13 percent in 2005. Lower interest expenditures as the debt declines will support the redirection of spending toward the public investment program and other poverty reduction efforts.

15. **The government recognizes that the full clearance of arrears is essential to restore order in the public finances and ensure the credibility of government as a diligent economic agent.** A recent study assessed the extent of public cross-debt involving central government, municipalities, the social security fund (INPS), and public and parapublic enterprises. Following this study, the government has agreed to settle 4.8 billion CVEsc (equivalent to 5.5 percent of GDP) in several installments. The government has also paid part of its old arrears to the oil companies for past subsidies on fuel supplied to Electra. The government is firmly committed to repaying remaining arrears and staying current on all its payment obligations throughout the program and beyond. To prevent a recurrence of the arrears buildup that has occurred among municipalities and autonomous public agencies, including their failure to remain current in payments for energy and other inputs, the central government will work directly with these entities to strengthen their financial management capacities and practices. If the arrears problem persists despite these efforts, the central government will take direct measures to assert fiscal discipline; for example, such measures may include government meeting energy payments on their behalf, and deducting the corresponding amounts from government transfers to the entities concerned.

16. **The government will maintain its efforts to reinforce and strengthen revenue collection.** Tax reforms over recent years, including the introduction of VAT and streamlining of import and consumption taxes, have made a substantial contribution toward reducing economic distortions, improving the transparency of the tax system, and strengthening overall revenue performance. In the PSI program, the government will give particular attention to pushing ahead with improvements already underway in revenue administration, and to further widening the tax base through rationalization of tax incentives and exemptions. In both areas, assistance has been provided by the IMF Fiscal Affairs Department (FAD). Following FAD advice, the complex system of tax exemptions will be reformed to ensure that exemptions will be granted only according to clearly defined economic criteria that correspond to the national development strategy, and regulated under a single law that will abolish the multitude of scattered norms currently in place. As noted below, these reforms will be part of the 2006–07 program.

17. **Additional structural measures will be taken to help contain fiscal risks and reinforce the macroeconomic targets set out above.** Reform efforts will include:

- improving the productivity of the civil service;
- strengthening capacities and procedures for formulating, executing, monitoring, and auditing the budget; and
- implementing a clear strategy for supporting production of electricity and water, including the automatic tariff adjustment mechanism.

18. **The government is determined to move ahead with reforms to public administration.** These reforms will focus on improving civil service capacities and productivity within the constraints of the overall wage bill. The government will give particular attention to ensuring that staffing levels are consistent with departmental requirements, and that wage structures provide appropriate incentives for performance and for the recruitment and retention of qualified staff, without putting undue pressure on private sector wages. In preparing for reform and rationalization of administrative structures, and following guidelines issued by the Council of Ministers, the Ministry of Finance and Public Administration has issued a circular requiring section heads in government departments to submit to the Directorate-General of Public Administration a list reflecting staffing needs and personnel available for mobility. Supporting these reform efforts will be the new civil servants database, recently established with the help of the World Bank. The above circular also mandates that Autonomous Funds, Autonomous Services, and Public Institutes that fail to submit the requested information will not receive monthly transfers. The government has imposed a freeze on promotions in public administration while it takes stock of reform requirements and directions. To further tighten fiscal control, the Public Treasury will not be responsible for meeting the costs of staff contracted by local health and education authorities in excess of budget limits.

19. **The government's public sector reforms include a wide range of measures to strengthen the budget process, from the formulation stage to final audit.** Some specific measures are discussed below in the program for 2006–07. These reforms are shaped in part by the Country Financial Accountability Assessment (CFAA) action plan, which the authorities are implementing with the support of the World Bank, the Netherlands, and other donors. Key steps in this area include developing a new national plan of public accounts, introducing a medium-term expenditure framework, strengthening public sector procurement practices, and introducing a new fiscal register. The recently developed SIGOF system provides a highly effective tool for real-time control of budget execution and monitoring, and the government intends to support the further development of this system and its expansion to other parts of the public sector. The authorities are seeking additional external assistance to move ahead with these initiatives.

20. **The government's energy policy is focused on supporting improvements in the quality of life of Cape Verdeans, improving the economy's competitiveness, ensuring stable supplies of energy, and preserving the environment.** This policy is directed in part at promoting conservation and alternative energy sources to reduce Cape Verde's

dependence on oil imports. To address persistent and growing concerns about service quality, especially concerning supplies of electricity and water, an integrated approach is needed involving the strengthening of the regulatory environment for the sector and increased investment in production and distribution. In particular:

- As part of its overall energy strategy, the government intends to strengthen legal and regulatory structures to support a competitive energy market, safeguard consumers, and increase discipline and transparency. In support of these measures, the government will reinforce institutional capacities for energy administration and develop a specific legal and regulatory framework for the subsector of electricity and fuel.

- ARE, the autonomous economic regulatory authority, has full authority to establish a tariff policy that both reflects costs and provides incentives for gains in efficiency. This policy needs to take into account the government's recent elimination of fuel subsidies, and to include full implementation of the automatic mechanism to adjust tariffs in light of changes in input costs and efficiency gains. ARE has guaranteed to the government that these requirements will be met by June 1, 2006.

- Investment in energy infrastructure is essential to increase efficiency and to ensure wider and easier access of the population to energy and water services. The government seeks the full cooperation and commitment of Electra to implement its investment plan for improving production and distribution. The government also calls on donor support to ensure that progress is made in this area.

Monetary policy and financial sector reforms

21. **Medium-term monetary policy will be geared, as in the past, towards safeguarding the exchange rate peg with the euro as an anchor for low inflation.** In order to provide a further cushion against external shocks and underpin investors' confidence into the peg, macroeconomic policies under the PSI program will be designed to support a further build-up of international reserves of at least 0.1 months of prospective imports per year—equivalent to around ½ percent of current GDP. Drawing on technical assistance from the IMF, the authorities will also strengthen the operational framework for monetary policy, including the development of intermediate monetary indicators to guide liquidity management and other dimensions of policy conduct. In-house capacity for tracking large external capital flows will be built, including to gauge the interest sensitivity of emigrant deposits and other private flows.

22. **In strengthening the financial sector, the government is committed to a wide ranging set of measures which, among other aspects, will ensure that the regulation and supervision of financial institutions, including International Financial Institutions (IFIs), is in line with best international practice.** Initiatives in this area will be guided by an Action Plan being drafted by a multidisciplinary task force organized by the BCV. Among other inputs, the task force will consider the recommendations of a November 2005 technical assistance mission from the Monetary and Financial Systems Department (MFD) of the IMF. The authorities will ensure in particular that there is sufficient growth in institutional capacities for regulation and supervision of the financial sector. Furthermore, development of

IFIs will be taken at a careful pace, with proper measures in place to protect the system against potential financial abuse and to safeguard Cape Verde's reputation and access to the international financial system. To the extent that IFIs engage in transactions with residents, these activities take place under the same prudential standards as apply to domestic banks. In the context of developing the legislative and institutional framework, including for anti-money laundering and combating the financing of terrorism (AML/CFT), the authorities will seek to bring this framework into line with international standards. In this regard, the Action Plan and all relevant activities therein will be discussed with the stakeholders and the donor community to ensure its adequacy and to secure technical and financial support for its implementation.

23. **The authorities will look further into obstacles to growth in bank lending to the private sector.** Reducing the cost of capital will be an important goal of monetary policy and financial sector development in the next few years. Growth of credit to the private sector will be further supported by enhancing the regulatory and legislative framework to protect lenders and strengthening banks' capacity to provide project-based lending. Reforms in the financial sector will also aim to improve credit risk management, expand access to credit for SMEs, and increase competition in the financial market.

Other structural reforms

24. **In parallel with the fiscal and financial sector measures outlined above, the government plans to implement ambitious reforms to enhance competitiveness, strengthen the business environment, and hence promote private sector led growth.** Against this background, trade reforms are proceeding in the context of WTO accession, for which a decision is expected during 2006; labor market reforms are being discussed with the goal of increasing the economy's capacity to create jobs and improving working conditions; a modern regulatory framework has been drafted in order to advance with the liberalization of the telecom market; and administrative barriers to private sector initiatives are being removed, including by the introduction of modern information technology in the provision of public services under the e-government initiative.

IV. POLICIES FOR 2006–07

25. **Within the general medium-term strategy described above, the government has specific policy targets it plans to meet in 2006–07**. These policies are intended to underpin a sustained pickup in growth and reduction in inflation following the short-term impact of increases in regulated prices during 2006.

Fiscal measures

26. **In addressing some key sources of fiscal concern, including eliminating subsidies and clearing arrears, the 2006 budget has taken important steps toward supporting the medium-term macroeconomic strategy of the PSI program.** Policies for 2007 will be geared toward further strengthening the fiscal position. Consistent with the objective of reducing domestic debt to 20 percent of GDP by 2009, government net domestic borrowing will be limited to at most 0.8 percent of GDP in 2006 (contributing to budgeted arrears

clearance of 1.7 percent of GDP) and 0.9 percent in 2007 (in line with arrears clearance anticipated in 2007). As a result, domestic debt, net of deposits but including arrears, is projected to decline from 32.7 percent of GDP at end-2005 to 25 percent at end-2007.

27. **To support these fiscal goals, the government is committed to ongoing restraint of current spending, combined with structural reforms to improve revenue performance, reduce fiscal risks, and improve financial management.** Specific measures the government plans to implement in 2006–07 include:

- **Rationalizing and streamlining tax incentives and exemptions.** As discussed above, the currently complex and fragmented approach to granting exemptions will be reformed, with exemptions granted instead according to clearly defined economic criteria and regulated under a single law. To effect these reforms, the government intends to submit draft legislation to the National Assembly by mid-2007.

- **Implementing the automatic mechanism to adjust electricity and water tariffs in line with changes in input costs and efficiency gains.** As noted above, ARE has guaranteed it will implement this mechanism by June 1, 2006.

- **Completing the privatization agenda.** Among the few enterprises remaining on this agenda, privatization of EMPROFAC (a pharmaceuticals distributor), ENAPOR (the port operator), and INTERBASE (a fish freezing company) is expected within 2006. A new management team will restructure TACV (the national airline) under a one-year consultancy contract beginning in June 2006, and privatization is expected in 2007.

- **Establishing a macroeconomic policy unit in the Ministry of Finance and Public Administration.** The government recognizes that such a unit is needed to improve the formulation of fiscal policy and its coordination with overall macroeconomic objectives. A unit will be established and staffed by December 2006.

- **Strengthening internal and external audit processes.** Priorities for the first year of the program will be the completion and implementation of the laws on reorganization and mandates of the TdC, and the National Chart of Public Accounts.

Monetary and financial sector policies

28. **Complementing these fiscal efforts, monetary policy during 2006–07 aims at further enhancing the credibility of the exchange rate peg.** Gross international reserves of the BCV are programmed to increase by CVEsc 2.1 million in 2006 and 2.3 million in 2007 (to 3.2 months of prospective imports). The reduction in growth of net credit to the central government should allow for an expansion in credit to the private sector in the range of 14 percent in 2006 and 2007, while broad money is expected to expand in line with nominal GDP growth. The central bank is committed to actively utilizing the monetary instruments at its disposal (including required reserves, its standing facilities, and open market type operations) in order to control liquidity and achieve the monetary targets established under the program. The program ceilings on net domestic assets of the BCV are set out in Table 1.

The BCV will also move forward during 2006–07 in tracking gross inflows and outflows of emigrant deposits to support its analysis of the interest sensitivity of these flows.

29. **Measures to strengthen the financial sector in 2006–07 will draw on the recommendations of the task force noted above.** Over 2006–07, priorities include:

- continuing to expand the institutional capacity of the BCV to conduct supervision;
- signing formal information sharing agreements with home country supervisors of subsidiaries and branches established in Cape Verde;
- reviewing and reforming as necessary the legislative and regulatory framework of IFIs in light of the task force report, including licensing procedures and criteria (especially for autonomous companies), secrecy provisions, and branching into third countries; and
- amending as necessary the AML/CFT legislation to bring it at par with the 2003 FATF/CFT standards.

The authorities are committed to addressing these priorities by mid-2007.

V. Program Monitoring

30. **Program implementation will be monitored according to assessment criteria and benchmarks presented in Tables 1 and 2 (attached)**. The definitions of the variables monitored as quantitative assessment criteria and benchmarks are contained in the Technical Memorandum of Understanding (attached). The program will also include, as assessment criteria, the equivalent of the standard performance criteria concerning the exchange and trade system that apply in Fund financial arrangements. Program implementation and the economic results associated with the program will be subject to two reviews per annum. The first review will be expected to be completed by end-November 2006 based on end-September 2006 assessment criteria and benchmarks, the second by end-February 2007 based on end-December 2006 criteria, and the third review by end-August 2007 based on end-June 2007 criteria. Reviews will proceed on a half-yearly basis thereafter. The quantitative criteria will be monitored on a quarterly basis.

Table 1. Cape Verde: Quantitative Assessment Criteria and Benchmarks for 2006–07 Under the PSI [1, 2]

	2005	Cumulative flows from End-December 2005 2006				Cumulative flows from End-December 2006 2007			
	Dec.	March	June	Sep.	Dec.	March	June	Sep.	Dec.
	Level Actual	Indicative target	Indicative target	Assessment criteria	Assessment criteria	Indicative target	Indicative target	Indicative target	Indicative target
Quantitative targets				(Billions of Cape Verde escudos)					
Ceiling on net domestic borrowing of the central government [3]	...	...	-0.9	-1.4	-1.8	-0.1	-0.1	-0.2	-0.2
Ceiling on net domestic assets of the central bank [3]	5.8	...	-0.4	-0.6	-0.9	-0.2	-0.4	-0.6	-0.8
Ceiling on the accumulation of new domestic payment arrears by the central government	5.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
				(Millions of U.S. dollars)					
Ceiling on the accumulation of new external debt arrears by the central government [4]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Ceiling on the contracting or guaranteeing of non-concessional external debt with original maturity of more than one year by the central government [5]	...		10.0	10.0	20.0	5.0	10.0	15.0	20.0
Ceiling on the outstanding stock of nonconcessional external debt with a maturity of less than one one year by the central government [4, 6]	0.0	0.0	0.0	...	0.0	0.0	0.0	0.0	0.0
				(Millions of euros)					
Floor on net international reserves of the Bank of Cape Verde (BCV) [7]	137.0	…	9.5	13.8	19.0	5.2	10.4	15.2	20.9
Memorandum item: **Program assumptions**				(Billions of Cape Verde escudos)					
Nonproject external financial assistance, including credit line (program assumption)	...	…	1.6	2.3	3.1	0.5	1.0	1.6	2.1
External debt service	...	…	1.4	2.1	2.8	0.7	1.4	2.1	2.8
Clearance of end-2005 stock of domestic arrears	5.3	…	-0.9	-1.3	-1.7	-0.3	-0.6	-0.9	-1.2

[1] Quantitative assessment criteria and benchmarks are described in the technical memorandum of understanding.

[2] For purposes of calculating program adjusters, foreign currency amounts will be converted at current exchange rates.

[3] Excluding borrowing for clearance of arrears and net late payments. The ceiling will be adjusted downward (upward) by the cumulative downward (upward) deviations in external debt service and upward (downward) by the cumulative downward (upward) deviation in nonproject external financial assistance relative to program assumptions.

[4] This assessment criterion is on a continuous basis.

[5] This assessment criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85), August 24, 2000), but also commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are rescheduling arrangements, the Portuguese credit line, and borrowings from the Fund.

[6] The term “debt” has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt. Excluded from this performance criterion are rescheduling arrangements, the Portuguese credit line, borrowings from the Fund, and normal import-related credits.

[7] The floor on net international reserves of the Bank of Cape Verde will be adjusted upward (downward) by exchange valuation gains (losses), by the cumulative downward (upward) deviations in external debt service, and downward (upward) by the cumulative downward (upward) deviations in nonproject external financial assistance relative to program assumptions.

Table 2. Summary of Structural Conditionality for 2006–07

Objectives	Conditionality	Timing
	Structural Assessment Criteria	
Reduce fiscal risks	Complete implementation of the automatic utility tariff adjustment mechanism	End-September 2006
	Structural Benchmarks	
Strengthen financial regulations	Complete Action Plan of task force assessing measures to ensure that financial sector regulation and supervision is in line with best international practice, including provisions applying to IFIs and AML/CFT	End-September 2006
Strengthen fiscal strategy	Establish macroeconomic policy unit in the Ministry of Finance and Public Administration	End-December 2006
Strengthen financial supervision	Sign formal information sharing agreements with home country supervisors of subsidiaries and branches established in Cape Verde	End-December 2006
Improve budget prioritization	Implementation of the MTEF	End-June 2007
Strengthen financial regulations	Implement recommendations of task force on financial sector reform (see above)	End-June 2007
Streamline tax incentives	Submit draft legislation to National Assembly on streamlining of tax incentives and exemptions	End-June 2007
Strengthen fiscal control	Implement laws to strengthen the Court of Auditors (TdC) and National Chart of Public Accounts	End-June 2007

APPENDIX I, ATTACHMENT II: CAPE VERDE—TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This memorandum sets out the understandings between the Cape Verdean authorities and the IMF staff regarding the definition of assessment criteria and indicative targets and reporting requirements under the first annual program supported by the Policy Support Instrument.

I. Quantitative Assessment Criteria and Indicative Targets

A. Net Domestic Borrowing Excluding for Clearance of Arrears and Net Late Payments

2. **Net domestic borrowing excluding for clearance of arrears and net late payments** is defined as the cumulative change since the start of the calendar year of the net credit to the central government from the banking and nonbanking sectors less (1) the cumulative clearance during the calendar year of the stock of arrears as of end-2005 and (2) the cumulative payments during the first three months of the calendar year of expenses authorized by the previous year's budget, and plus the expenses accrued during the current year that will be paid during the first three months of the next calendar year as provisioned for in the budget law (late payments or *atrasados*). The ceiling will be adjusted downward (upward) by the cumulative downward (upward) deviations in external debt service and upward (downward) by the cumulative downward (upward) deviations in nonproject external financial assistance relative to program assumptions.

3. **Net credit to the central government from the banking and nonbanking system** is defined as the overall position of the main central government institutions vis-à-vis the banking and nonbanking system—that is, the stock of all outstanding claims on the central government (loans, advances), and all other government debt instruments, such as long-term government securities) held by the central bank, commercial banks, and nonbank institutions, less all deposits held by the central government with the central bank and with commercial banks. The INPS is not included in central government accounts. Net credit to the central government excludes claims on the Trust Fund (TCMFs).

4. **Reporting requirements.** Data on the implementation of the budget compiled by the Ministry of Finance and Economic Planning will be provided on a quarterly basis, to be submitted not later than five weeks after the end of each quarter, including (i) government domestic revenue by category; (ii) external budget support grants; (iii) government expenditure, including primary current expenditure, domestic and external interest payments, and capital expenditure, including domestically and budget support financed capital expenditure and estimates of externally project financed capital expenditure; (iv) the gross payment and gross accumulation of domestic accounts payable (*atrasados*); (v) the gross payment and gross accumulation of domestic payments arrears; (vi) external loan receipts and principal payments; (vii) external arrears payments and accumulation; (viii) bank and nonbank financing; (ix) privatization and land sale receipts; and (x) any other revenue, expenditure, or financing not included above.

5. For the purposes of this memorandum, privatization and land proceeds will be understood to mean all monies received by the government from the sale or concessioning of a public company, organization, or facility to a private company or companies, organization(s), or individual(s), as well as any proceeds generated from the sale of government land and the liquidation of a public company, less restructuring costs.

B. Net Domestic Assets of the Central Bank

6. The ceiling on the cumulative change, from the beginning of calendar-year 2006, in net domestic assets of the BCV constitutes an assessment criterion. Net domestic assets (NDA) of the BCV are defined as reserve money minus net foreign assets of the BCV, evaluated at the current end-of-period exchange rates. The program ceilings for NDA will be adjusted downward (upward) by the cumulative downward (upward) deviations in external debt service and upward (downward) by the cumulative downward (upward) deviations in nonproject external financial assistance relative to program assumptions. For purposes of calculating the adjusters, these flows will be valued at current exchange rates. Reserve money comprises bank reserves and deposits of the monetary institutions and private sector with the central bank, as well as cash in circulation.

7. **Reporting requirements.** The preliminary monthly balance sheets of the BCV and the consolidated commercial banks will be transmitted on a monthly basis, with a maximum delay of five weeks. The definitive version of the monthly balance sheet of the BCV will be provided as soon as available.

C. Ceiling on Nonconcessional External Debt Contracted or Guaranteed by the Central Government

8. Under the program, ceilings on medium- and long-term, as well as on short-term, nonconcessional external debt constitute assessment criteria. These assessment criteria are on a continuous basis. Nonconcessional external debt is defined as debt contracted or guaranteed by the central government with a grant element of less than 35 percent, calculated using currency-specific commercial interest reference rates (CIRRs) published by the Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD). Debt rescheduling and debt reorganization are excluded from the limits on nonconcessional external debt. The limits on new nonconcessional external debt contracted or guaranteed by the central government (excluding borrowing from the Fund) are specified in Tables 1 and 2 of the memorandum of economic and financial policies. The definition of short-term nonconcessional external debt excludes normal short-term (less than one year) import-related financing. The Portuguese government's precautionary credit line in support of the exchange rate peg is also excluded from the definition of nonconcessional external debt. In addition, the central government will not guarantee any external debt contracted by state enterprises and will maintain the policy of not guaranteeing private sector external debt. The assessment criterion on medium- and long-term nonconcessional external indebtedness applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85), 8/24/00) but also to commitments contracted or guaranteed for which value has not been received. With respect to the assessment criterion on short-term nonconcessional external indebtedness, the term

"debt" has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85), 8/24/00).

9. **Reporting requirements.** The government of Cape Verde will consult with Fund staff before assuming any liabilities in circumstances where they are uncertain whether the instrument in question falls under the assessment criterion. Details of all new external debt (including government guarantees), indicating terms of debt and creditors, will be provided on a quarterly basis within five weeks of the end of each quarter.

D. Net International Reserves of the Central Bank

10. The floor on the cumulative change, from the beginning of calendar-year 2006, in net international reserves (NIR) of the BCV constitutes a assessment criterion under the program. The NIR of the BCV are defined as gross international reserves of the BCV net of its external reserve liabilities, calculated at the current exchange rates. Gross reserves of the BCV are those that are readily available (i.e., liquid and marketable and free of any pledges or encumbrances), controlled by the BCV and held for the purposes of meeting balance of payments needs and intervening in foreign exchange markets. They include gold, holdings of SDRs, the reserve position at the IMF, holdings of foreign exchange and traveler's checks, demand and short-term deposits at foreign banks abroad, fixed-term deposits abroad that can be liquidated without penalty, and any holdings of investment-grade securities. External liabilities of the BCV comprise liabilities to nonresidents contracted by the BCV with an original maturity of less than a year, any net off-balance-sheet position of the BCV (futures, forwards, swaps, or options) with either resident and nonresidents, any arrears on principal and interest to external creditors and suppliers, and purchases from the IMF. The program floors for the NIR will be adjusted upward (downward) by the cumulative downward (upward) deviations in external debt service and downward (upward) by the cumulative downward (upward) deviations in nonproject external financial assistance relative to program assumptions. For purposes of calculating the adjusters, these flows will be valued at current exchange rates.

11. **Reporting requirements.** A table on the NIR prepared by the BCV will be transmitted on weekly basis, with a maximum delay of two weeks.

E. Nonaccumulation of New Domestic Payments Arrears

12. As part of the program, the government will not accumulate any new domestic payments arrears. This will be monitored through the monthly execution of the cash-flow plan and the corresponding release of budget appropriations. For programming purposes, a domestic payment obligation to suppliers is deemed to be in arrears if it has not been paid within the normal grace period of 60 days (30 days for government salaries and debt service) or such other period either specified by the budget law or contractually agreed with the supplier after the verified delivery of the concerned goods and services, unless the amount or the timing of the payment is subject to good faith negotiations between the government and the creditor.

13. **Reporting requirements.** The Ministry of Finance and Economic Planning, through the D.G.T., will submit on a quarterly basis a detailed table of the stock of domestic payments arrears, including the accumulation, payment, rescheduling and write-off of domestic payments arrears during the quarter. The data are to be provided within four weeks after the end of the quarter.

F. Nonaccumulation of External Payments Arrears

14. As part of the program, the government will not accumulate any new external payments arrears on a continuous basis. This will be monitored through the monthly execution of the cash-flow plan and the corresponding release of budget appropriations.

15. External arrears are defined as total external debt-service obligations of the government that have not been paid by the time they are due, except where agreements between the government and creditors explicitly provide for a grace period after such obligations falling due. External arrears exclude arrears on external debt, pending the conclusion of debt-rescheduling agreements.

16. **Reporting requirements.** Data on (i) debt-service payments; and (ii) external arrears accumulation and payments will be transmitted on a quarterly basis by the Ministry of Finance and Economic Planning, within five weeks of the end of each quarter. In addition, the government will inform the Fund staff immediately of any accumulation of external arrears.

II. Structural Assessment Criteria[1]

A. Complete Implementation of the Automatic Utility Tariff Adjustment Mechanism

17. The implementation of the automatic utility tariff adjustment mechanism will be deemed complete when (i) the technical specifications, including the adjustment schedule and specification of cost changing events that will trigger a tariff adjustment, have been agreed upon between Electra and the autonomous economic regulatory authority (ARE); (ii) the details of the adjustment mechanism have been published; (iii) tariff levels are brought in line with the agreed mechanism; (iv) ARE's authorization of tariff adjustments reflects full and transparent application of the mechanism; and (v) ARE publishes its decisions on tariff adjustments without delay.

III. Other Data Requirements for Program-Monitoring Purposes

18. Data on exports and imports, including volume and prices and compiled by the Director of Customs and the BCV, will be transmitted on a quarterly basis within five weeks after the end of each quarter. A preliminary quarterly balance of payments, compiled by the BCV, will be forwarded within five weeks after the end of each quarter.

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[1] See Table 2 of the memorandum of economic and financial policies.

19. The monthly disaggregated consumer price index for Cape Verde, compiled by the National Institute of Statistics (INE), will be transmitted monthly, within five weeks after the end of each month.

20. Documentation of all measures taken by the government to meet assessment criteria or indicative benchmarks under the program will be transmitted to the Fund staff within one week after the day of implementation.

APPENDIX II: CAPE VERDE—EXTERNAL AND PUBLIC DEBT SUSTAINABILITY ANALYSIS (DSA) [1] [2]

Cape Verde's debt level has increased in recent years. Despite the rising cost of servicing this debt, the country's external sustainability ratios indicate a low probability of debt distress under the baseline scenario and in the face of plausible shocks. High domestic debt and its implication for fiscal space, however, warrants focusing on total public debt in the analysis.

Background

1. The sustainability of Cape Verde's external and total public debt is assessed using the Fund-World Bank debt sustainability framework for low income countries. The previous DSA was carried out during the sixth review of the PRGF and Article IV consultation,[3] based on the outstanding stock of debt at end-2004. The analysis concluded that, under long-term economic scenarios that were in line with or more cautious than recent historical averages, Cape Verde's public debt appeared sustainable although vulnerable to a variety of possible economic shocks.

2. **Total public debt in Cape Verde has been above 80 percent of GDP for most of the last decade.[4]** At end-2005, debt stood at almost 90 percent of GDP, with interest payments accounting for nearly 10 percent of domestic revenues (2.2 percent of GDP).

3. **External public debt increased significantly in the 1990s, but has declined over recent years.** After peaking at 64 percent of GDP in 2001, external debt decreased to 54 percent of GDP at end-2005. Of this, 79 percent was owed to multilateral creditors, 18 percent to bilateral creditors, and less than 1 percent to commercial creditors. The World Bank (IDA) was the largest multilateral creditor, followed by the African Development Fund and BADEA. Portugal, Russia, and Germany accounted for over 65 percent of bilateral debt.

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[1] This DSA has been prepared jointly by staff of the IMF and the World Bank. The analysis is undertaken based on aggregate external debt data from the authorities, which have been revised since the last DSA.

[2] This analysis focuses on central government and government guaranteed public debt only, as comprehensive and reliable data on private external debt are not available. Private external debt contracted is believed to be around US$25 million. The outstanding amount and the terms of repayment of this debt are not known.

[3] Appendix I of IMF Country Report No. 05/320, 09/2005.

[4] Due to its relatively high income per capita, Cape Verde is not eligible for HIPC assistance nor does it qualify for debt forgiveness under the MDRI. Cape Verde's eligibility for concessional financing through the PRGF and IDA is based on the small island exception.

Table 1. Cape Verde: Net Present Value of Disbursed Debt Outstanding, 2006–11
(Millions of U.S. dollars)

	2005	2006	2007	2008	2009	2010	2011
	Actual	Projected					
Multilaterals	395.6	218.0	217.1	214.7	210.0	205.2	199.9
IDA	213.9	106.4	108.6	110.3	111.3	112.0	112.7
IMF	12.7	10.1	10.4	10.1	9.1	7.5	5.2
Others	169.0	101.5	98.1	94.3	89.6	85.8	81.9
Official bilaterals	93.9	63.7	55.9	46.7	37.8	32.3	26.9
Paris Club	65.3	42.8	35.8	28.6	21.7	18.3	15.0
Non-Paris Club	28.6	17.4	16.9	15.4	13.9	12.3	10.7
Export credit agencies	4.8	3.5	3.3	2.7	2.2	1.7	1.2
Commercial	14.4	12.2	9.9	7.5	5.0	2.4	0.0

Sources: Cape Verdean authorities; and staff estimates and projections.

4. **Domestic debt has increased sharply since the debt restructuring operation in the late 1990s.** This increase has reflected the government's assuming the debt of some large public enterprises as part of their privatization, fiscal slippages, and, more recently, increased recognition of domestic arrears. Central government net domestic debt including arrears amounted to 33 percent of GDP at end-2005. Of this, 30 percent was short term. Commercial banks were the major creditors, holding 55 percent of total government debt. The social security fund INPS held the largest share of the debt to nonbanks (26 percent).

5. **The assumptions underlying this DSA are based on the medium-term macroeconomic framework agreed with the authorities during discussions for the PSI and long-term projections agreed between the Fund and the Bank staff.** Over the longer term, real GDP growth is expected to average 5 percent while inflation gradually decreases to around 2 percent annually in line with rates in the euro area. Exports are projected to grow by around 9 percent a year on average, below their historical average growth rate. A cautious approach has been taken toward these assumptions; for example, growth could be higher than projected if foreign direct investment continues to grow at a strong pace.

6. **Grants are assumed to decrease to 5 percent of GDP by 2026, and new borrowing terms may also worsen as a result of Cape Verde's graduation from low income country status in 2008.** Hence, while the baseline scenario assumes no commercial borrowing in 2006–09, commercial loans are assumed to gradually replace loans from multilateral creditors and the Paris Club in the long run. Thus, at the end of the projection period (2026), loans from multilaterals account for 30 percent of total borrowing, whereas commercial borrowing accounts for 40 percent. As a result, the concessionality of new borrowing decreases from 27 percent in 2006 to 8 percent by 2026.

Table 2. Cape Verde: Macroeconomic Baseline Assumptions, 2006–11 (Percent, unless otherwise indicated)							
	Historical Average (1996–2005)	2006	2007	2008	2009	2010	2011
Real GDP growth	6.8	5.5	6.0	6.3	6.6	6.6	6.3
Inflation	2.6	6.2	0.2	0.3	2.1	2.1	2.1
Exports of G&S (U.S. dollars terms)	14.8	3.8	5.0	6.5	6.4	12.6	10.5
Imports of G&S (U.S. dollars terms)	8.9	9.2	9.4	9.3	8.6	8.3	6.7
Current Account Balance (percent of GDP)	-9.3	-6.8	-9.9	-10.9	-11.0	-9.9	-7.3
Foreign direct investment (percent of GDP)	3.5	2.1	3.4	4.0	4.4	2.0	2.1
Grant element of new external borrowing	...	27.3	27.5	29.2	31.1	26.6	25.8
Exchange rate (national currency per U.S. dollar, p.a.)	101.3	93.1	92.9	92.6	92.4	92.3	92.1
Public sector revenue and grants (percent of GDP)	30.3	34.1	33.6	34.3	35.0	33.6	30.5

7. **In the event that highly concessional loans fall short of the baseline assumptions, an alternative scenario assesses the impact of covering the resulting gap by a limited amount of less concessional borrowing, as provided for under the PSI program.** To assess the maximum impact of such borrowing, the alternative scenario assumes that the full amount allowed under the program (US$20 million per year) is provided on commercial rather than highly concessional terms over 2006–09. The alternative scenario assumes, moreover, that in the long run, commercial loans will replace concessional loans at a faster pace than in the baseline, thus accounting for 60 percent of total borrowing in 2026.

8. **The DSA incorporates new information that has become available since the previous exercise in 2005.** The main additions are as follows:

- government guaranteed domestic debt is included in the total debt stock at end-2005;
- newly recognized domestic arrears and cross-debt with the public administration and institutes (amounting to CV Esc 5.3 billion) are included in the domestic debt stock;
- revised projections on contributions to the social security fund stemming from the pension reform of January 1, 2006 are incorporated in the fiscal framework;
- oil subsidies are eliminated from the projections, following the government's 2006 budget decision to this effect;
- WEO oil price projections are updated as of the winter 2006 baseline.

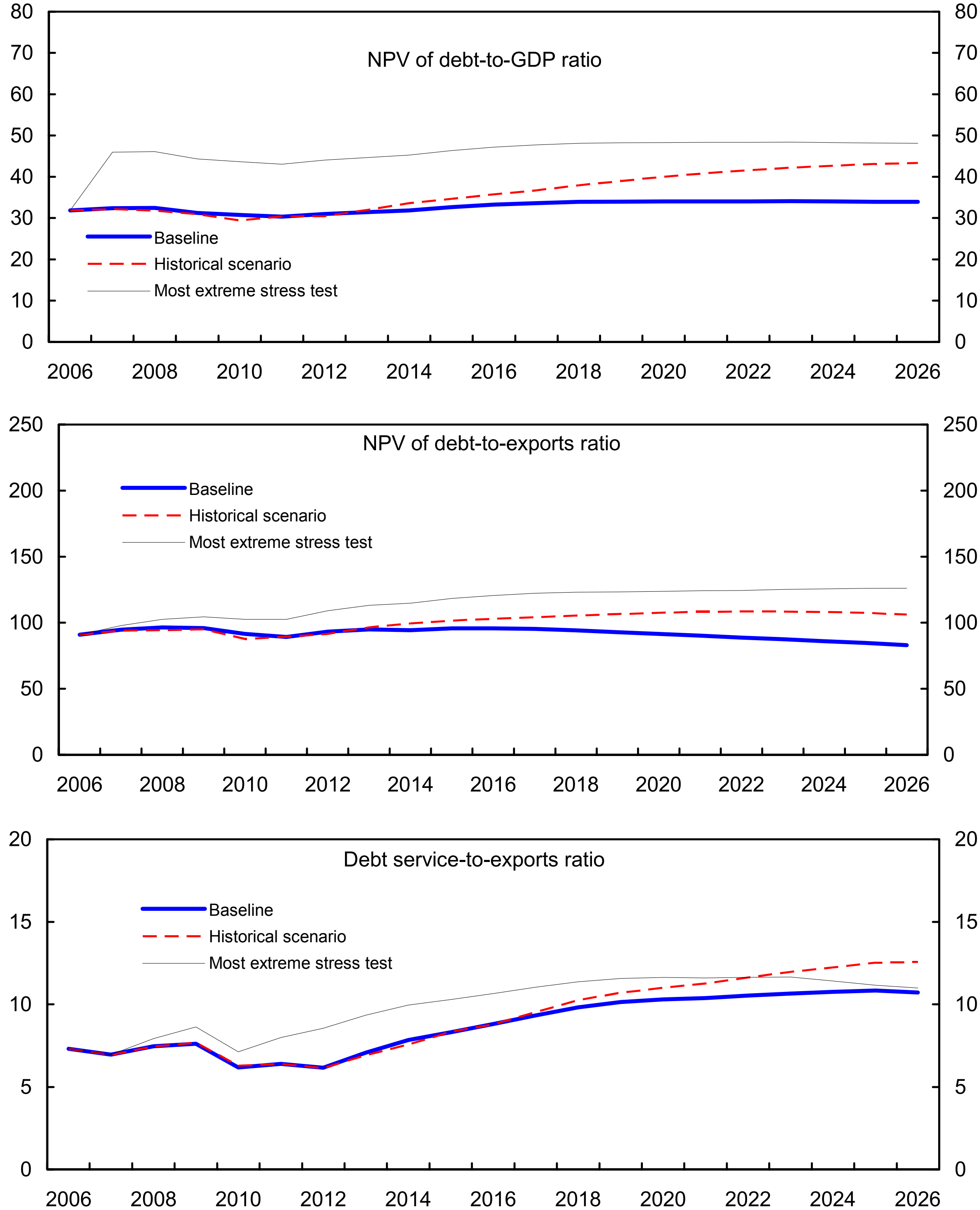
External debt sustainability

9. **Despite the gradual reduction in concessionality of new loans, Cape Verde's debt stock and flow indicators under the baseline scenario remain below their policy-dependent thresholds throughout the projection period.** The NPV of debt is projected to increase minimally from 32 to 34 percent of GDP, and to decrease in terms of exports (from 91 to 83 percent). Reflecting worsening borrowing terms, however, debt service

payments increase from 7 to 11 percent of exports. In the alternative scenario, the debt service-to-export ratio would increase to 15 percent over the projection horizon.

10. **Standard bound tests suggest that even in the presence of external shocks, Cape Verde does not appear vulnerable to debt distress.** However, a one-time 30 percent exchange rate depreciation relative to the baseline would bring the NPV of debt-to-GDP very close to the threshold of 50 percent and keep it permanently at this level. The debt outlook also appears sensitive to further worsening of borrowing terms and a decline in nondebt creating flows (implying higher debt flows). While the former would increase the NPV of debt-to-exports to 126 percent, a decrease in transfers by one standard deviation compared to the historical average would push the debt service-to-export ratio from 7.6 percent in 2006 to nearly 12 percent in 2023.

Figure II 1. Cape Verde: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2006-2026
(Percent)



Source: Staff projections and simulations.

Table 3. Cape Verde: External Debt Burden Indicators				
		Cape Verde's ratios		
	Thresholds [1]	2006	2016	2026
NPV of debt in percent of:				
GDP	50	32	33	34
Exports	200	91	96	83
Revenues [2]	300	95	119	120
Debt service in percent of:				
Exports	25	7	9	11
Revenues [2]	35	7	11	15

Sources: Ministry of Finance and Public Administration, and staff estimates.

[1] Based on Cape Verde's 2005 classification as a strong performer.

[2] Including grants.

Fiscal sustainability

11. **The fiscal DSA is based on the assumption of ongoing fiscal consolidation in the context of lower grant inflows.** The DSA also builds in and extends the PSI program goal of a sizeable reduction in domestic debt as a share of GDP. Specifically, domestic debt would decrease to 16 percent of GDP by 2026. Domestic public revenues are projected to be constant at 24 percent of GDP over the long term: this is lower than the recent historical average and medium-term projections, reflecting prudent assumptions on the scope for ongoing gains in revenue collection. The resulting overall fiscal deficit in the projection period averages 3.1 percent of GDP.

12. **The baseline scenario depicts a decline in the NPV of debt-to GDP ratio, in line with efforts to decrease the debt burden and create fiscal space for emerging pressures.** This ratio decreases to 50 percent in 2026 from 60 percent in 2006. While the NPV of debt-to-revenues shows a small improvement, debt service increases sharply from 10 to 20 percent of revenues by 2026—reflecting the worsening of borrowing terms in the baseline scenario. In the alternative scenario, with a more rapid deterioration in borrowing terms, debt service would rise to 22 percent of revenues by 2026.

13. **Standardized alternative shocks increase the NPV of Cape Verde's public debt and drive debt service to much higher levels**. The most extreme test, which assumes that the primary balance stays at its historical average minus 1 standard deviation in 2007–08, increases the NPV of debt-to-GDP to 73 percent in 2008 and keeps it above the baseline throughout the projection period. The same shock stabilizes the NPV of debt to-revenues at around 200 percent in the long run, while increasing debt service-to-revenues to 23 percent by 2026.

14. **Recent simulations by the World Bank indicate that the INPS pension system will move into a cash flow deficit by 2037.** While beyond the projection period in the current DSA, this outlook clearly has negative implications for contingent fiscal liabilities and public debt in Cape Verde over the long run. As in other pension systems around the world, early efforts to address these imbalances would lower the eventual burden of adjustment.

Conclusion

15. **In summary, the debt sustainability analysis suggests that Cape Verde is not likely to face debt distress despite the rising debt service burden, given that sustainability indicators are kept below the thresholds over the forecast horizon.** The analysis incorporates cautious assumptions on macroeconomic variables and builds in a considerable worsening of borrowing terms in the long run. These results are contingent upon the reduction of currently high debt ratios, highlighting the need for prudent fiscal and debt management in the period ahead, including to ensure that debt service costs do not crowd out high priority, poverty reducing spending.

Figure II 2. Cape Verde: Indicators of Public Debt Under Alternative Scenarios, 2006-2026[1]

(Percent)

Chart 1. NPV of Debt-to-GDP Ratio

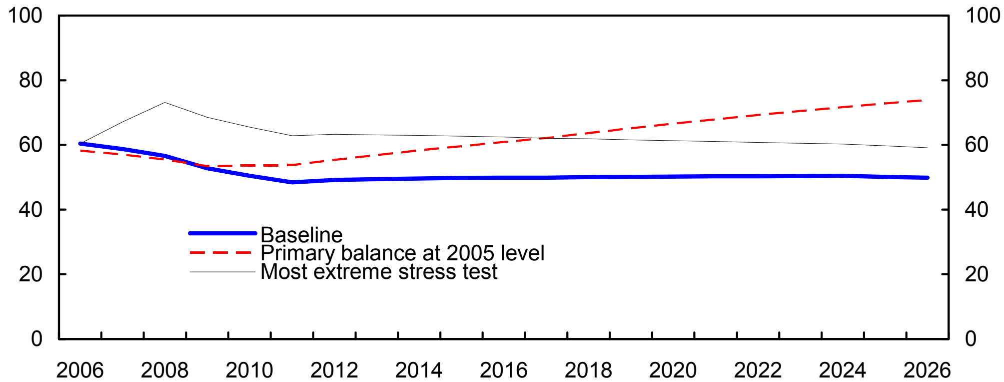


Chart 2. NPV of Debt-to-Revenue Ratio[2]

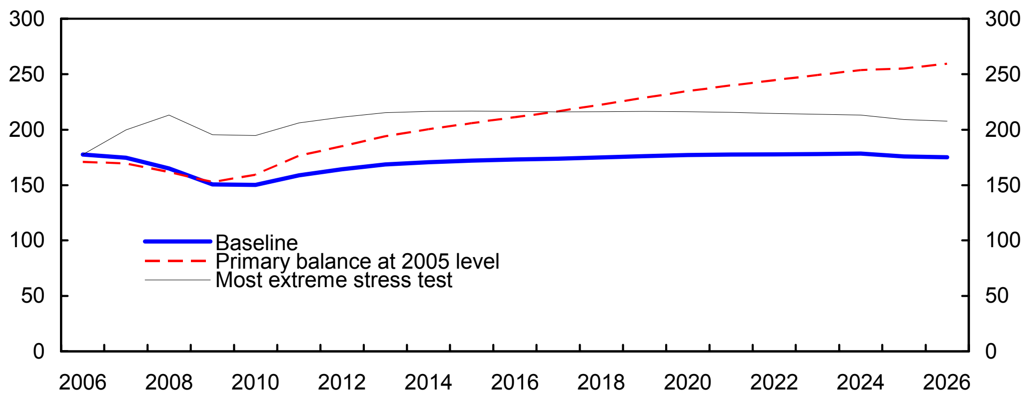
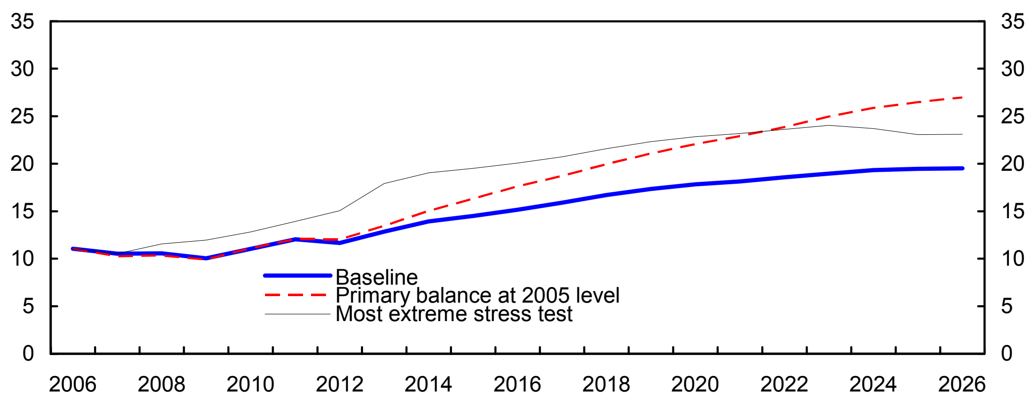


Chart 3. Debt Service-to-Revenue Ratio[2]



Source: Staff projections and simulations.

[1] Most extreme stress test is test that yields highest ratio in 2016.

[2] Revenue including grants.

Table II 4a. Cape Verde: External Debt Sustainability Framework, Baseline Scenario, 2003–2026 [1]

(Percent of GDP, unless otherwise indicated)

	Actual			Historical Average [6]	Standard Deviation [6]	Estimate	Projections								
	2003	2004	2005			2006	2007	2008	2009	2010	2011	2006–11 Average	2016	2026	2012–2026 Average
External debt (nominal) [1]	**64.3**	**59.3**	**51.3**			**51.4**	**51.0**	**50.2**	**47.7**	**46.0**	**44.5**		**43.3**	**38.1**	
Of which: public and publicly guaranteed (PPG)	64.3	59.3	51.3			51.4	51.0	50.2	47.7	46.0	44.5		43.3	38.1	
Change in external debt	1.4	-5.1	-8.0			0.1	-0.4	-0.8	-2.5	-1.7	-1.5		0.0	-0.4	
Identified net debt-creating flows	-5.8	4.5	-0.9			2.0	3.6	4.0	3.6	5.0	2.6		3.9	3.7	
Noninterest current account deficit	**10.4**	**13.7**	**3.9**	**9.3**	**3.1**	**6.1**	**9.3**	**10.3**	**10.4**	**9.4**	**6.7**		**7.2**	**5.6**	6.6
Deficit in balance of goods and services	36.1	37.6	29.6			32.0	34.0	35.2	35.4	33.8	31.9		23.3	14.9	
Exports	31.3	31.9	36.2			35.0	34.2	33.7	32.6	33.6	34.0		34.7	40.8	
Imports	67.4	69.5	65.8			67.0	68.1	68.9	68.0	67.4	65.9		58.0	55.7	
Net current transfers (negative = inflow)	-26.6	-25.2	-28.4	-26.2	2.0	-28.1	-26.7	-26.7	-26.7	-26.0	-26.6		-17.0	-9.0	-14.8
Other current account flows (negative = net inflow)	0.9	1.2	2.8			2.2	2.1	1.8	1.7	1.6	1.4		0.9	-0.3	
Net FDI (negative = inflow)	**-1.9**	**-2.2**	**-2.0**	**-3.5**	**2.4**	**-2.1**	**-3.4**	**-4.0**	**-4.4**	**-2.0**	**-2.1**		**-2.0**	**-1.3**	-2.0
Endogenous debt dynamics [2]	**-14.3**	**-7.0**	**-2.9**			**-2.0**	**-2.3**	**-2.4**	**-2.4**	**-2.3**	**-2.0**		**-1.2**	**-0.6**	
Contribution from nominal interest rate	0.6	0.7	0.6			0.6	0.6	0.6	0.6	0.6	0.6		0.8	1.2	
Contribution from real GDP growth	-2.2	-2.5	-3.2			-2.6	-2.9	-3.0	-3.0	-2.9	-2.7		-2.0	-1.8	
Contribution from price and exchange rate changes	-12.7	-5.2	-0.3			…	…	…	…	…	…		…	…	
Residual (3–4) [3]	**7.2**	**-9.5**	**-7.1**			**-1.9**	**-4.0**	**-4.7**	**-6.1**	**-6.7**	**-4.1**		**-4.0**	**-4.0**	
Of which: exceptional financing	-53.1	-1.2	3.7			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Of which: capital grant	-3.1	-2.5	-2.1			-1.4	-2.4	-2.9	-3.1	-3.5	-1.1		-1.1	-1.1	
NPV of external debt [4]	...	...	31.0			31.9	32.4	32.5	31.2	30.8	30.3		33.3	33.9	
Percent of exports	...	...	85.5			90.9	94.7	96.4	95.9	91.6	89.1		95.8	83.0	
NPV of PPG external debt	**...**	**...**	**31.0**			**31.9**	**32.4**	**32.5**	**31.2**	**30.8**	**30.3**		**33.3**	**33.9**	
Percent of exports	...	...	85.5			90.9	94.7	96.4	95.9	91.6	89.1		95.8	83.0	
Debt service-to-exports ratio (percent)	10.5	11.3	8.8			7.3	7.0	7.5	7.6	6.2	6.4		8.8	10.7	
PPG debt service-to-exports ratio (percent)	10.5	11.3	8.8			7.3	7.0	7.5	7.6	6.2	6.4		8.8	10.7	
Total gross financing need (billions of U.S. dollars)	0.1	0.1	0.1			0.1	0.1	0.1	0.1	0.1	0.1		0.2	0.4	
Noninterest current account deficit that stabilizes debt ratio	9.0	18.8	11.9			6.0	9.7	11.1	12.9	11.1	8.2		7.2	6.0	
Key macroeconomic assumptions															
Real GDP growth (percent)	4.7	4.4	5.8	6.8	2.2	5.5	6.0	6.3	6.6	6.6	6.3	6.2	5.0	5.0	5.0
GDP deflator in U.S. dollar terms (change in percent)	25.2	8.8	0.5	0.9	11.0	1.7	1.5	1.7	3.2	2.6	2.7	2.2	2.0	2.0	2.0
Effective interest rate (percent) [5]	1.3	1.2	1.1	1.5	0.3	1.4	1.2	1.2	1.3	1.3	1.4	1.3	2.1	3.2	2.4
Growth of exports of G&S (U.S. dollar terms, percent)	27.2	15.8	20.7	14.8	11.7	3.8	5.0	6.5	6.4	12.6	10.5	7.5	9.0	9.0	8.4
Growth of imports of G&S (U.S. dollar terms, percent)	28.9	17.2	0.6	8.9	11.8	9.2	9.4	9.3	8.6	8.3	6.7	8.6	6.5	6.7	5.9
Grant element of new public sector borrowing (percent)	...	...	...	...	...	27.3	27.5	29.2	31.1	26.6	25.8	27.9	8.7	7.6	8.2

Source: Staff simulations.

[1] Includes central government external debt.

[2] Derived as [r - g - r(1+g)]/(1+g+r+gr) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and r = growth rate of GDP deflator in U.S. dollar terms.

[3] Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

[4] Assumes that NPV of private sector debt is equivalent to its face value.

[5] Current-year interest payments devided by previous period debt stock.

[6] Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table II 4b. Cape Verde: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2006–2026 (concluded)

(Percent)

	Estimate	Projections						
	2006	2007	2008	2009	2010	2011	2016	2026
				NPV of debt-to-GDP ratio				
Baseline	32	32	32	31	31	30	33	34
A. Alternative scenarios								
A1. Key variables at their historical averages in 2007–2026 [1]	32	32	32	31	29	30	36	43
A2. New public sector loans on less favorable terms in 2007–2026 [2]	32	33	35	34	34	35	42	52
B. Bound tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007–08	32	33	33	32	32	31	34	35
B2. Export value growth at historical average minus one standard deviation in 2007–08 [3]	32	33	35	33	33	32	34	34
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2007–08	32	37	41	40	39	39	42	43
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007–08 [4]	32	36	41	39	39	38	37	34
B5. Combination of B1-B4 using one-half standard deviation shocks	32	36	41	40	39	38	40	39
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 [5]	32	46	46	44	44	43	47	48
				NPV of debt-to-exports ratio				
Baseline	91	95	96	96	92	89	96	83
A. Alternative scenarios								
A1. Key variables at their historical averages in 2007–2026 [1]	91	94	94	95	88	89	103	106
A2. New public sector loans on less favorable terms in 2007–2026 [2]	91	98	103	105	103	102	121	126
B. Bound tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007–2008	91	95	96	96	92	89	96	83
B2. Export value growth at historical average minus one standard deviation in 2007–08 [3]	91	98	108	107	102	99	104	88
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2007–08	91	95	96	96	92	89	96	83
B4. Net nondebt creating flows at historical average minus one standard deviation in 2007–08 [4]	91	107	122	121	115	111	108	84
B5. Combination of B1–B4 using one-half standard deviation shocks	91	95	101	100	96	93	95	79
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 [5]	91	95	96	96	92	89	96	83
				Debt service ratio				
Baseline	7.3	7.0	7.5	7.6	6	6	9	11
A. Alternative scenarios								
A1. Key variables at their historical averages in 2007–2026 [1]	7	7	7	8	6	6	9	13
A2. New public sector loans on less favorable terms in 2007–2026 [2]	7	7	7	8	7	6	8	15
B. Bound tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007–08	7	7	7	8	6	6	9	11
B2. Export value growth at historical average minus one standard deviation in 2007–08 [3]	7	7	8	8	7	7	10	11
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2007–08	7	7	7	8	6	6	9	11
B4. Net nondebt creating flows at historical average minus one standard deviation in 2007–08 [4]	7	7	8	9	7	8	11	11
B5. Combination of B1-B4 using one-half standard deviation shocks	7	7	7	8	6	7	9	10
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 [5]	7	7	7	8	6	6	9	11
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) [6]	8	8	8	8	8	8	8	8

Source: Staff simulations.

1 Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), noninterest current account in percent of GDP, and nondebt creating flows.

2 Assumes that the interest rate on new borrowing is 2 percentage points higher than in the baseline, while grace and maturity periods are the same.

3 Export values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4 Includes official and private transfers and FDI.

5 Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

6 Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table II 5a. Cape Verde: Public Sector Debt Sustainability Framework, Baseline Scenario, 2003–2026

(Percent of GDP, unless otherwise indicated)

	Actual					Estimate	Projections																		
	2003	2004	2005	Historical Average [5]	Standard Deviation [5]	2006	2007	2008	2009	2010	2011	2015	2006-11 Average	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2012-26 Average
Public sector debt [1]	86.5	90.7	88.3			79.9	77.3	74.3	69.2	65.7	62.6	60.6		60.0	59.3	58.6	57.8	57.2	56.6	56.1	55.7	55.3	54.7	50.7	
Of which: foreign-currency denominated	57.5	54.0	54.0			51.3	50.9	50.1	47.7	46.0	44.5	43.4		43.3	43.0	42.4	41.7	41.0	40.4	39.8	39.4	38.9	38.4	34.6	
Change in public sector debt	-0.7	4.2	-2.4			-8.4	-2.6	-3.0	-5.1	-3.5	-3.1	-0.6		-0.6	-0.7	-0.7	-0.7	-0.7	-0.6	-0.5	-0.4	-0.4	-0.6	-4.0	
Identified debt-creating flows	-12.8	-8.5	7.8			-3.0	-1.5	-1.7	-4.1	-3.5	-3.0	-0.5		-0.5	-0.7	-0.7	-0.7	-0.7	-0.6	-0.5	-0.4	-0.4	-0.6	-0.5	
Primary deficit	1.0	-4.2	2.9	5.0	6.6	5.3	2.5	2.3	1.0	0.2	0.3	1.4	1.9	1.3	1.2	1.0	1.0	1.0	1.0	1.0	1.0	1.0	0.7	0.7	1.1
Revenue and grants	27.6	34.1	31.2			34.1	33.6	34.3	35.0	33.6	30.5	29.0		28.8	28.7	28.6	28.5	28.3	28.3	28.3	28.3	28.3	28.5	28.5	
Of which: grants	5.5	10.9	7.1			9.0	8.9	9.2	9.3	8.9	6.3	5.2		5.1	5.0	4.9	4.8	4.7	4.7	4.7	4.7	4.7	5.0	5.0	
Primary (noninterest) expenditure	28.6	29.9	34.1			39.3	36.1	36.6	36.0	33.8	30.8	30.3		30.1	29.9	29.6	29.4	29.3	29.3	29.3	29.3	29.3	29.3	29.2	
Automatic debt dynamics	-13.8	-4.3	4.9			-8.3	-3.9	-4.0	-5.0	-3.6	-3.4	-1.9		-1.9	-1.8	-1.8	-1.7	-1.6	-1.5	-1.5	-1.4	-1.4	-1.3	-1.3	
Contribution from interest rate/growth differential	-3.7	-2.3	-4.3			-6.2	-4.1	-4.2	-4.5	-3.4	-3.1	-1.9		-1.9	-1.8	-1.8	-1.7	-1.6	-1.5	-1.5	-1.4	-1.4	-1.3	-1.3	
Of which: contribution from average real interest rate	0.2	1.4	0.7			-1.6	0.4	0.4	0.1	0.9	0.8	1.0		1.0	1.0	1.1	1.1	1.1	1.2	1.2	1.2	1.3	1.3	1.3	
Of which: contribution from real GDP growth	-3.9	-3.6	-4.9			-4.6	-4.6	-4.6	-4.6	-4.3	-3.9	-2.9		-2.9	-2.9	-2.8	-2.8	-2.8	-2.7	-2.7	-2.7	-2.7	-2.6	-2.6	
Contribution from real exchange rate depreciation	-10.1	-2.1	9.2			-2.1	0.2	0.2	-0.5	-0.2	-0.3	0.0		...	...	...	...	...	...	...	...	...	...	...	
Denominator = 1 + g	1.0	1.0	1.1			1.1	1.1	1.1	1.1	1.1	1.1	1.1		1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes	12.1	12.7	-10.1			-5.4	-1.2	-1.3	-1.0	0.0	-0.1	0.0		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-3.5	
Other Sustainability Indicators																									
NPV of public sector debt	...	...	...			60.4	58.7	56.6	52.8	50.5	48.4	49.8		49.9	49.9	50.0	50.1	50.2	50.3	50.3	50.4	50.4	50.2	49.9	
Of which: foreign-currency denominated	...	...	...			31.8	32.3	32.4	31.2	30.7	30.3	32.6		33.3	33.6	33.9	34.0	34.0	34.0	34.0	34.1	34.0	33.9	33.9	
Of which: external	...	...	...			31.8	32.3	32.4	31.2	30.7	30.3	32.6		33.3	33.6	33.9	34.0	34.0	34.0	34.0	34.1	34.0	33.9	33.9	
NPV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...	...		...	...	...	...	...	...	...	...	...	...	...	
Gross financing need [2]	35.6	25.4	35.9			37.5	33.3	32.0	28.9	26.7	25.0	24.4		23.8	23.2	22.8	22.6	22.7	22.7	22.7	22.8	22.8	22.7	22.5	
Billions of U.S. dollars	0.3	0.2	0.4			0.4	0.4	0.4	0.4	0.4	0.4	0.5		0.5	0.6	0.6	0.6	0.7	0.7	0.8	0.8	0.9	1.0	1.0	
NPV of public sector debt-to-revenue ratio (percent) [3]	...	...	...			177.4	174.8	164.9	150.6	150.1	158.8	172.0		173.1	173.7	175.0	176.1	177.1	177.4	177.8	178.1	178.4	175.8	175.2	
Of which: external	...	...	...			93.4	96.2	94.4	89.1	91.4	99.3	112.7		115.3	117.1	118.6	119.3	120.0	120.2	120.3	120.6	120.4	119.0	119.0	
Debt service-to-revenue ratio (percent) [3, 4]	23.4	7.3	14.9			11.0	10.5	10.5	10.0	11.0	12.0	14.5		15.2	15.9	16.7	17.3	17.8	18.1	18.6	19.0	19.3	19.5	19.5	
Primary deficit that stabilizes the debt-to-GDP ratio	1.7	-8.4	5.2			13.6	5.1	5.2	6.0	3.7	3.4	1.9		1.9	1.8	1.8	1.7	1.6	1.6	1.5	1.4	1.4	1.4	4.8	
Key macroeconomic and fiscal assumptions																									
Nominal GDP (local currency)	80	82	87			98	105	114	125	136	148	195		209	224	240	257	275	294	315	337	361	387	415	
Real GDP growth (percent)	4.7	4.4	5.8	6.8	2.2	5.5	6.0	6.3	6.6	6.6	6.3	5.0	6.2	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Average nominal interest rate on public debt (percent)	3.1	3.0	2.6	3.5		2.4	2.3	2.4	2.4	3.5	3.5	3.8	2.7	3.8	3.9	3.9	4.0	4.1	4.2	4.3	4.4	4.5	4.5	4.6	4.0
Average nominal interest rate on forex debt (percent)	1.3	1.2	1.2	1.5	0.3	1.4	1.2	1.2	1.3	1.3	1.4	2.0	1.3	2.1	2.2	2.3	2.4	2.6	2.7	2.8	2.9	3.0	3.1	3.2	2.4
Average nominal interest rate on domestic debt (percent)	6.6	6.5	4.6	6.5	2.2	4.0	4.4	4.5	4.7	8.3	8.3	8.2	5.7	8.2	8.2	8.2	8.2	8.1	8.1	8.0	8.0	8.0	7.9	7.8	8.1
Average real interest rate (percent)	0.3	1.7	0.8	1.6	1.8	-1.9	0.5	0.6	0.1	1.3	1.3	1.7	0.3	1.8	1.8	1.9	2.0	2.1	2.2	2.3	2.3	2.4	2.5	2.5	2.0
Real discount rate on foreign-currency debt (percent)	2.9	2.3	2.1	3.0	0.5	2.1	2.9	2.9	2.9	2.9	2.9	2.9	2.8	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9
Average real interest rate on domestic currency debt (percent)	2.1	7.7	4.2	4.6	3.9	-2.6	3.0	3.2	1.7	5.7	5.6	6.1	2.8	6.0	6.0	6.1	6.1	6.0	5.9	5.9	5.9	5.8	5.7	5.7	6.0
Exchange rate (LC per U.S. dollar)	87	81	93	99.6	14.6	93	93	92	92	92	92	92	92.5	92	92	92	92	92	92	92	92	92	92	92	92.1
Nominal depreciation of local currency (percentage change in LC per U.S. dollar)	-17.0	-7.3	15.5	2.6	12.5	-0.5	-0.3	-0.3	-0.2	-0.1	-0.1	0.0	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Exchange rate (U.S. dollar per LC)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Nominal appreciation (increase in US dollar value of local currency, percent)	20.4	7.8	-13.4	-1.1	12.9	0.5	0.3	0.3	0.2	0.1	0.1	0.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real exchange rate depreciation (percent, + indicates depreciation)	-18.9	-3.8	18.3	2.8	12.4	-4.1	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, percent)	4.4	-1.1	0.4	1.9	2.9	6.7	1.3	1.3	3.0	2.4	2.5	2.0	2.9	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
U.S. Inflation rate (GDP deflator, percent)	2.0	2.6	2.8	2.0	0.5	2.8	2.0	2.0	2.0	2.0	2.0	2.0	2.1	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Growth of real primary spending (deflated by GDP deflator, percent)	-5.0	9.3	20.5	4.5	17.6	21.8	-2.7	7.8	4.9	0.2	-3.1	4.4	4.8	4.4	4.1	4.1	4.3	4.6	5.0	5.0	5.0	5.0	4.9	4.9	4.6
Grant element of new external borrowing (percent)	...	...	...	...	...	27.3	27.5	29.2	31.1	26.6	25.8	8.6	27.9	8.7	8.3	7.7	7.5	7.6	7.6	7.7	8.0	7.6	7.6	7.6	...

Sources: Cape Verdean authorities, and staff estimates and projections.

[1] Includes central government total debt.

[2] Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

[3] Revenues including grants.

[4] Debt service is defined as the sum of interest and amortization of medium and long-term debt.

[5] Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table II 5b. Cape Verde: Sensitivity Analysis for Key Indicators of Public Debt, 2006–2026

	Estimate	Projections						
	2006	2007	2008	2009	2010	2011	2016	2026
NPV of Debt-to-GDP Ratio								
Baseline	60	59	57	53	50	48	50	50
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	60	61	61	60	62	63	73	87
A2. Primary balance is unchanged from 2005	58	57	55	53	54	54	61	74
A3. Permanently lower GDP growth [1]	60	59	57	54	52	51	58	74
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2007–08	60	60	59	56	54	53	57	61
B2. Primary balance is at historical average minus one standard deviations in 2007–08	60	67	73	69	66	63	62	59
B3. Combination of B1-B2 using one half standard deviation shocks	60	64	68	63	60	58	58	56
B4. One-time 30 percent real depreciation in 2007	60	72	68	64	61	58	58	60
B5. 10 percent of GDP increase in other debt-creating flows in 2007	60	68	65	61	59	56	57	55
NPV of Debt-to-Revenue Ratio [2]								
Baseline	177	175	165	151	150	159	173	175
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	177	181	177	172	185	208	258	320
A2. Primary balance is unchanged from 2005	171	170	162	153	159	176	211	259
A3. Permanently lower GDP growth [1]	177	176	167	154	155	167	198	255
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2007–08	177	177	171	159	160	172	197	215
B2. Primary balance is at historical average minus one standard deviations in 2007–08	177	200	213	196	195	206	217	208
B3. Combination of B1-B2 using one half standard deviation shocks	177	191	197	180	179	190	201	195
B4. One-time 30 percent real depreciation in 2007	177	213	199	182	180	190	202	211
B5. 10 percent of GDP increase in other debt-creating flows in 2007	177	202	191	175	174	184	196	193
Debt Service-to-Revenue Ratio [2]								
Baseline	11	11	11	10	11	12	15	20
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	11	10	11	10	12	13	21	31
A2. Primary balance is unchanged from 2005	11	10	10	10	11	12	18	27
A3. Permanently lower GDP growth [1]	11	11	11	10	11	12	17	26
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2007–08	11	11	11	10	11	13	17	23
B2. Primary balance is at historical average minus one standard deviations in 2007–08	11	11	12	12	13	14	20	23
B3. Combination of B1-B2 using one half standard deviation shocks	11	11	11	11	12	13	18	22
B4. One-time 30 percent real depreciation in 2007	11	11	11	11	12	13	17	23
B5. 10 percent of GDP increase in other debt-creating flows in 2007	11	11	12	11	12	13	18	21

Sources: Cape Verdean authorities; and staff estimates and projections.

[1] Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).

[2] Revenues are defined inclusive of grants.

APPENDIX III: RELATIONS WITH THE FUND

(As of May 31, 2006)

I. Membership Status: Joined: November 20, 1978 — Article XIV

II. General Resources Account

	SDR Million	%Quota
Quota	9.60	100.00
Fund holdings of currency	9.59	99.93
Reserve Position	0.02	0.17
Holdings Exchange Rate		

III. SDR Department

	SDR Million	%Allocation
Net cumulative allocation	0.62	100.00
Holdings	0.01	1.04

IV. Outstanding Purchases and Loans

	SDR Million	%Quota
PRGF Arrangements	8.64	90.00

V. Latest Financial Arrangements

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
PRGF	Apr 10, 2002	Jul 31, 2005	8.64	8.64
Stand-by	Feb 20, 1998	Mar 15, 2000	2.50	0.00

VI. Projected Payments to Fund

(SDR million, based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2006	2007	2008	2009	2010
Principal		0.12	0.49	0.98	1.48
Charges/Interest	0.05	0.07	0.06	0.06	0.05
Total	0.05	0.19	0.56	1.04	1.53

VII. Implementation of HIPC Initiative: Not Applicable

VIII. Implementation of MDRI Assistance: Not Applicable

IX. Safeguards Assessments

Under the Fund's safeguards assessment policy, the Bank of Cape Verde (BCV) is subject to an assessment with respect to the PRGF arrangement approved on April 10, 2002. A safeguards assessment of the BCV was completed on December 9, 2002. The assessment identified certain vulnerabilities in the reporting, internal control, and audit areas, and made appropriate recommendations, as reported in "Semi-Annual Review of PRGF, PRGF-HIPC, and SDA Investments,'' issued on November 11, 2003. The BCV has implemented all safeguards assessment recommendations, and has requested a new, voluntary, safeguards assessment.

X. Exchange Arrangements

The currency of Cape Verde, the Cape Verde escudo, has been pegged to the euro at a rate of CVEsc 110.3 per EUR 1 since January 4, 1999. Cape Verde accepted the obligations under Article VIII of the Articles of Agreement effective July 1, 2004. Cape Verde maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

XI. Article IV Consultation

Discussions for the 2005 Article IV consultation together with the sixth and final review under the PRGF arrangement were held in Praia during March 8–23,2005. The Executive Board concluded the discussions of the Article IV consultations and completed the sixth review under the PRGF arrangement on May 25, 2005 (Country Report No. 05/320, dated 05/12/05); and www.imf.org.

XII. Technical Assistance

Since 1985, the Fund has provided technical assistance to the Bank of Cape Verde, the Ministry of Finance, and, more recently, the National Institute of Statistics in several areas: (i) The Bank of Cape Verde has received technical assistance from MFD in organization and methods, management of external debt, monetary and banking statistics, accounting, credit, and foreign exchange operations, management of public debt, and the separation of the functions of the Bank of Cape Verde, as well as on the choice of exchange rate regime. It has also received technical assistance from STA in monetary and balance of payments statistics. (ii) The Ministry of Finance has received technical assistance from FAD in organization and budgetary procedures, budgeting, tax policy, and tax administration; and (iii) the National Institute of Statistics has received technical assistance in national accounts and price statistics. Cape Verde is a participant in STA's GDDS Regional Project for Lusophone Africa, and its metadata were posted on the DSBB in February 2004. It is receiving technical assistance to implement the GDDS plan for improvement in the context of this project.

Most recently, technical assistance has been provided in the following areas:

FAD

- June 2004 follow-up visit to help the authorities move to a VAT, including the rationalization of the import tariff and the overhaul of the domestic indirect tax system. Many visits and a two-year resident advisor have gone into this effort.
- October 2004, one mission to review tax administration, including VAT implementation, and one mission to assist the assessment of tax exemptions and incentives.

STA

- National accounts (November 2003 and January–February 2006), balance of payments statistics (February 2004), government finance statistics (March 2004, April 2006), price statistics (June 2004, May–June 2006).

MFD

- Safeguards assessment (July 2003), accounting, financial systems regulations, monetary operations and liquidity management (April and May 2004), banking supervision, liquidity management, exchange regime and reserves management (November 2005, March–April 2006, and June 2006).

XIII. Resident Representative: None.

APPENDIX IV: CAPE VERDE—IMF-WORLD BANK RELATIONS

(June 16, 2006)

Partnership in Cape Verde's development strategy

1. The Joint staff advisory note (JSAN) of the Government's full Poverty Reduction Strategy Paper (PRSP) was discussed in the Board in January 2005. Cape Verde's strategy focuses on five key pillars for public intervention: (i) promoting good governance; (ii) improving competitiveness and private-sector-led growth; (iii) fostering human capital development; (iv) strengthening social security and solidarity; and (v) improving infrastructure and land use management. The main development challenges for the country revolve around: (i) maintaining macroeconomic stability given external vulnerabilities and uncertainties surrounding resources flows; (ii) achieving further improvements in governance, especially in a decentralized context; (iii) reforming social expenditure programs to reflect the changing nature of demand; and (iv) promoting stronger growth and poverty reduction through improvements in the business climate.

World Bank-Fund collaboration in specific areas

2. The Fund and the Bank continue to collaborate in many areas, including fiscal operations and tax reform; public enterprise reform and privatization; public expenditure management; civil service and pension system reform; utility regulation and private sector development; and the strengthening of human resource development and the poverty reduction strategy.

World Bank Group strategy

3. The Bank's FY05–08 Country Assistance Strategy (CAS) was discussed by the Board in February 2005. It is fully aligned with the PRSP, and supports efforts in the areas of (i) macroeconomic stability and sound finance and budget systems; (ii) private-led growth through an enhanced investment climate and increased competitiveness through public-private partnerships in infrastructure; and (iii) social programs aimed at alleviating poverty and inequity.

World Bank Group activities and assessment of country policies

IDA portfolio

4. The Bank's strategy aims at supporting the implementation of the Government's poverty reduction strategy by focusing in areas where the Bank has a comparative advantage. The CAS calls for a significant shift towards programmatic lending, complemented by a multi-sectoral investment operation, to the extent possible every two years. Contributing to the harmonization agenda, Bank group support aims to catalyze other donors and build partnerships. Most projects in the IDA portfolio have been rated satisfactory or better.

5. With regard to programmatic lending, a second Poverty Reduction Support Credit (PRSC-2, US$10 million equivalent) was approved by the Board in June 2006 and, as of June 16, 2006, is not yet effective. It focuses on three main objectives: (i) promote good governance, reinforce effectiveness, and guarantee equity; (ii) develop and upgrade human capital; and (iii) improve the effectiveness and sustainability of the social protection system.

6. With regard to investment lending, the current World Bank investment portfolio gives a priority to stabilizing the macroeconomic framework, strengthening competitiveness (infrastructure and private sector) and building capacity in the social sector (HIV/AIDS).

7. IDA's assistance in terms of strengthening the country's physical infrastructure and competitiveness, is covered as follows:

- The Energy/Water Project aims to improve the supply of power, water, and sanitation systems, to increase operational and end-use efficiency in the power and water, sectors, to lower the barriers to the development of renewable energy sources, and to foster the sound management of water resources.

- The Growth and Competitiveness Project aims to broaden the base of private participation in Cape Verde's economic growth, enhance private sector competitiveness and further develop its financial sector. This would be achieved through a series of actions supported by the project, notably: (a) financial sector reform, including pension reform; (b) investment climate reform, which includes, but is not limited to: (i) tax reform, (ii) alleviation of administrative barriers, (iii) improvement of supply chains, and (iv) legal reform; (c) post privatization and divestiture reforms; and (d) private sector and institutional capacity building. The project thus helps to sustain the Government's poverty alleviation efforts by generating increased employment opportunities through improved international competitiveness.

- The Road Sector Support Project aims to support critical road transport infrastructure needs through all, or a combination of the following approaches: (i) improving access roads linking villages and rural areas to main roads; (ii) filling critical gaps to establish a minimum continuous network within an island with the construction of a short section of new road (8–10 km. on St. Nicolau Island); and (iii) filling a major gap in an island network, through the construction of bridges or providing access to a chronically poor access zone.

8. In the social sectors, an HIV/AIDS Project supports (i) mitigation of the health and socioeconomic impact of HIV/AIDS at individual, household, and community levels, thus sustaining an economically productive population, and (ii) establishment of a strong and sustainable national capacity to respond to the epidemic.

9. The World Bank, IFC, and MIGA will continue to coordinate their respective roles to support development activities in Cape Verde.

Assessment of country policies

10. The authorities of Cape Verde and development partners, including the Bank, have undertaken a substantial body of analytic work to assess key social, structural, and sectoral development policies and identify policy and institutional reform priorities for poverty reduction. It allowed *inter alia* the adoption in April 2003 of a Statement of development policies for private sector development, which was one of the basic framework to the preparation of the Growth and competitiveness project.

11. In FY06 and beyond, advisory services funded by the World Bank are in large part related to infrastructure, fisheries and economic management (public service reform). Proposed economic and sector work (ESW) includes core diagnostics, annual public expenditures reviews (PER) updates, and general economic work to sustain macroeconomic and sectoral dialogue. The following studies are planned: Investment Climate Assessment (FY06), Integrated CFAA/CPAR (FY07), Rural Development Assessment (FY07), Long term Growth and Competitiveness Study (FY08), Poverty Assessment Update (FY08).

12. As of June 16, 2006, the current IDA portfolio includes five credits, with associated credit amounts of about US$63 million equivalent and an undisbursed balance of about US$31 million. The involvement of the International Finance Corporation (IFC) in Cape Verde remains limited (see tables below).

Questions may be referred to Mr. Madani M. Tall (tel.: 011-221-849-5010),
Ms. Manuela Francisco (tel: 202-473-8209), Mr. Iradj Alikhani (tel: 202-458-0345) or
Ms. Francoise Perrot (tel: 202-473-4465).

Statement of IDA Operations

(As of November 7, 2005, millions of U.S. dollars)

Credit No.	Projects	Principal Amount	Undisbursed	Approved Date	Closing Date
41750	PRSC II	10.00	10.41	30-Jun-06	30-May-07
32170	Roads Sector	15.00	10.53	19-May-05	31-Aug-10
37550	Growth & Competitiveness	11.50	6.81	13-May-03	28-Feb-08
36290	HIV/AIDS	9.00	0.21	28-Mar-02	31-Dec-06
32050	Energy/Water	17.50	3.65	11-May-99	30-Jun-04
	Total active projects	63.00	31.61		

Note: Disbursed amount may be higher than commitment (approved amount) due to exchange rate vis-à-vis SDR.

Statement of IFC Investments

(Millions of U.S. dollars)

			Original Gross Commitments				Disbursed	
FY Approv.	Company	Type of Business	Loan	Equity	Quasi	Partic	Loan	Equity Quasi Partic.
1992	Growela [1]	Shoe manu-facturing	0.15	0.00	0.00	0.00	0.15	0.00 0.00 0.00
2004	CECV [2]	Finance and insurances	5.58	0.00	0.00	0.00	5.58	0.00 0.00 0.00
Total portfolio			5.73	0.00	0.00	0.00	5.73	0.00 0.00 0.00

[1] Growela = shoe manufacturing.

[2] CECV = Caixa Economica de Cabo Verde.

APPENDIX V: CAPE VERDE—STATISTICAL ISSUES

1. **The quality of Cape Verde's economic and financial data are generally adequate for surveillance and program monitoring, although there is need for substantial improvements in some areas**. Weaknesses in the fiscal data—including with regard to the accounting of arrears and late payments, financing transactions, and the corresponding large statistical discrepancies in the provisional quarterly accounts submitted to parliament—is hampering the monitoring of some aspects of fiscal performance. Weaknesses in the national accounts, an outdated CPI that lacks sufficient details to adequately track the sources of inflation pressure, a lack of short-term activity indicators besides the confidence barometer, and gaps in the tracking of large external flows—notably FDI, emigrant deposits, and remittances—are other areas of particular concern.

2. **The authorities are taking important steps to strengthen statistics, but the statistical system still suffers from a shortage of financial and human resources.** A comprehensive master plan has been developed under the direction of the National Statistical Institute (INE), which assesses the need for upgrading the various agencies that constitute the statistical system and outlines the steps needed for broadening and improving all areas of statistics. The plan envisages data improvements in several areas, including national accounts statistics (annual and quarterly), business statistics (including a new business census), demographic and social statistics (including a household survey to update the poverty profile), trade statistics (retail and international trade), macroeconomic indicators, the regular update of the CPI basket (every half a decade), labor statistics, and sectoral statistics. Cape Verde's development partners have already committed a substantial part of the estimated US$15 million required to implement the plan over 2006–10.

3. **The authorities have signed up to the Fund's General Data Dissemination System (GDDS) in February 2004 and benefited from the technical assistance (TA) provided by STA under the GDDS project for Lusophone Africa.** The main purpose of this TA project was to assist the government of Cape Verde in implementing the plans to improve GDDS metadata, in particular as regards the adoption of the Government Finance Statistics Manual 2001 (*GFSM* 2001). In this context, a GFS mission visited the country in March 2004, and there was a recent follow up in April 2006. TA has also been provided in other areas, including national accounts, consumer prices (with a recent STA mission taking place in May–June 2006, in preparation for the launching of the new CPI), and balance of payments statistics.

Real sector

4. **Although some improvements have been made to the national accounts, significant weaknesses remain.** The timeliness of the data has improved, with the National Statistical Institute (INE) releasing production and expenditure based GDP numbers for 2002–03 in 2005 and providing production based GDP estimates 2004–05 to the mission in

May 2006. However, the lag is still large when compared to international standards. The base year for the constant price estimates is outdated, although INE is currently working on a complete overhaul of the national accounts. The overhaul includes updating the national accounts benchmark and base years from 1980 to 2002, and adopting the *1993 SNA*. The final objective is the timely compilation of GDP by industry and expenditure categories at current and constant prices as well as the institutional sector accounts.

5. **A full implementation of the *1993 SNA* would require a substantial improvement in the source data collection programs for which the capacity is currently lacking.** The 2006 STA mission found that there is a critical need for improving the timeliness and accuracy of the national accounts source data, in particular the business survey. The capacity of INE staff working on national accounts was found to be overstretched, assessing in detail and correcting individual source data entries—a task which in most countries is not undertaken by the national accounts compilers. The statistical master plan will address many of these challenges.

6. **A new CPI is expected to be released by January 2007. The current official CPI is obsolete, with** weights dating back to 1989, four years before the liberalization of imports that considerably changed the consumption pattern. INE has worked with the assistance of the National Statistics Institute of Portugal, and benefited from a STA CPI mission in April–May, 2006 on introducing the revised CPI. The new index will benefit from new weights, an updated commodity basket, and new compilation software.

Government finance

7. **Benefiting from TA support under the GDDS project for Lusophone Africa, progress has been made to improve fiscal data.** In terms of data provision, draft government accounts for 1998–2003 have been submitted to parliament for transmittal to the Court of Auditors (TdC), and provisional quarterly accounts for 2004 and 2005 have also been submitted to the parliament. However, capacity constraints have prevented the TdC from making rapid progress in the final auditing of the accounts.

8. **Serious quality concerns remain, particularly regarding data availability at a higher frequency**. The provisional quarterly fiscal accounts are subject to large statistical discrepancies and recording of arrears accumulations and clearance operations is not in line with best practices. Significant delay in donor reporting of project related financing prevents timely closure of accounts and the separate identification of budget and project financing is not possible under current reporting standards.

9. **The GFS compilation system is being upgraded as part of the ongoing reforms of the government's management and information systems.** Most accounts previously held with commercial banks have been consolidated at the central bank level. In addition, government agencies' reporting, as well as the coordination among the treasury, the budget

directorates, and the central bank, has improved, with the Ministry of Finance and Planning being the single point of commitment, execution, and monitoring of public expenditure.

10. **Steps for improving the coverage of extra-budgetary units were outlined during the STA GFS mission of April 2006.** During this mission important advances were also made in simplifying the conversion of budgetary classifications to *GFSM* 2001 classifications. However, technical problems with the institutional sectorization and budgetary registers are still to be resolved. Moreover, work remains to be done to change statistics on cash basis to accrual basis, and to define a methodology to obtain the stocks of assets and liabilities in terms of *GFSM* 2001.

Money and banking

11. **The quality of the monetary and financial statistics is adequate,** both in terms of the accuracy and timeliness of the data. However, more progress needs to be made by the BCV to start reporting monetary statistics to STA using the standardized report forms (SRFs), fully aligned with the recommendations of the *Monetary and Financial Statistics Manual*. Interest rate data need improvement. Published lending rates are based on posted lending rates and do not adequately reflect the actual weighted lending rates as customers frequently obtain better terms. Gaps in tracking the source and the direction of changes in emigrant deposits, moreover, cause difficulties for gauging the appropriateness of the monetary policy stance.

Balance of payments

12. **With technical assistance from STA, accuracy, periodicity and timeliness of balance of payments statistics compiled by BCV have continued to improve.** A greater use of surveys, combined with the International Transactions Reporting System implemented by the BCV, has permitted a significant expansion of data sources and statistical coverage, which, to a large extent, follow the recommendations of the 5th edition of the *Balance of Payments Manual*. Reporting of BOP data to AFR has been regular and quarterly data for the first quarter of 2006 are already disseminated on the BCV website. However, the timeliness of reporting of BOP statistics to STA needs to be improved. The latest data published in *IFS* refer to 2003.

External debt and arrears

13. **Despite the recent revision of the historical data on external debt, significant weaknesses in accounting still exist and hamper the preparation of reliable debt sustainability analyses.** Multilateral debt statistics regularly differ from data received by creditors and debt service projections cannot be reconciled with the debt stock.

Cape Verde: Common Indicators Required for Surveillance

(As of June 27, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	May-06	May-06	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Apr-06	May-06	M	M	M
Reserve/Base Money	Apr-06	May-06	M	M	M
Broad Money	Apr-06	May-06	M	M	M
Central Bank Balance Sheet	Apr-06	May-06	M	M	M
Consolidated Balance Sheet of the Banking System	Apr-06	May-06	M	M	M
Interest Rates[2]	Apr-06	May-06	M	M	M
Consumer Price Index	May-06	Jun-06	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Mar-06	Jun-06	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Mar-06	Jun-06	Q	Q	Q
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Mar-06	Jun-06	Q	Q	I
External Current Account Balance	Mar-06	Jun-06	Q	I	Q
Exports and Imports of Goods and Services	Mar-06	Jun-06	Q	I	Q
GDP/GNP	Dec-05	May-06	A	I	A
Gross External Debt	Dec-05	May-06	A	A	I

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I); and not available (NA).

Statement by the IMF Staff Representative
July 31, 2006

1. This statement provides an update on economic and policy developments since the issuance of the staff report. These developments do not change the thrust of the staff appraisal.

2. The government of Cape Verde has assumed majority ownership of the major electricity and water public utility, Electra. This followed an agreement reached on July 24 between the government and the Portuguese consortium EDP/ADP prompted by the intervention of the Portuguese government. Under the agreement, EDP/ADP will recapitalize Electra and the company's ownership structure will be changed to give the Cape Verde government and municipalities a majority share. The agreement does not appear to have fiscal implications for Cape Verde although full details are not yet available. The authorities have signaled that Electra will continue to be run on fully commercial terms.

3. The government of the United Kingdom has indicated that, as part of its debt relief initiative, the United Kingdom will pay its share (10 percent) of Cape Verde's debt service to IDA and the African Development Bank (AfDB) from January 1, 2006. The resources released by this payment, amounting to just over $0.5 million in 2006, will be spent on poverty reducing investments in line with Cape Verde's national poverty reduction plan.

4. CPI inflation was 0.5 percent in the month of June 2006 and 7 percent in the year to June. The latest monthly outturn includes a fall of 0.9 percent in food prices, reflecting a reversal of recent supply-induced shortfalls in fish, fruit, and vegetables, and a 7.4 percent rise in energy and water prices.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 06/100
FOR IMMEDIATE RELEASE
August 24, 2006

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2006 Article IV Consultation with Cape Verde

On July 31, 2006 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Cape Verde and approved Cape Verde's request for a three-year Policy Support Instrument (PSI).[1]

Background

Cape Verde's economic and policy performance has strengthened significantly over recent years. International reserves have built up, adding credibility to the exchange rate peg to the euro; the fiscal position has improved, with fiscal restraint maintained through the recent election cycle—a marked break from the past; and important progress has been made with privatization and other structural reforms. Reflecting the stronger policy environment, growth has averaged 5½ percent since 2000, supported by rising inflows of external financing from official and private sources.

Following a Fund staff-monitored program in the second half of 2001, the authorities' economic program in 2002–05 was supported by an arrangement with the IMF under the PRGF. With the PRGF arrangement having ended in July 2005, the government has requested that its economic program for 2006–09 be supported by the IMF under the PSI. The government's medium-term development strategy is set out in the Poverty Reduction Strategy Paper (PRSP), which focuses on combating poverty and promoting

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

private sector-led growth. In particular, the PRSP includes measures to strengthen education, training, health care, and sanitation, underpinned by improvements in governance and the development of infrastructure.

Considering recent developments, GDP growth is estimated to have increased to nearly 6 percent in 2005, supported by increased private investment—especially in tourism related construction—and a higher execution rate of public investment projects. After falling for much of 2003–05, prices have recently increased sharply: food prices have risen as a result of temporary, supply-driven factors, and regulated prices of fuel, electricity, and water have increased following the rise in international oil prices and the elimination of fuel subsidies (see below). In view of the negative impact of these price rises on private sector purchasing power, coupled with some delays in implementing the 2006 public investment program, GDP growth in 2006 may be slightly weaker than in 2005—possibly around 5½ percent.

The current account deficit declined to 4½ percent of GDP in 2005 (from over 14 percent of GDP in 2004), mainly because of strong growth of exports and remittances, along with importers' use of broader-based and cheaper sources of supplies. This improvement in the external position enabled Cape Verde's official international reserves to continue to build, reaching 3 months of prospective imports at the end of 2005 (up from 2.4 months a year earlier). Strong capital inflows, together with lower reserve requirements and slow private sector credit growth, have led to an increase in excess liquidity in the banking sector. In response, banks have increased their holdings of foreign assets and pursued domestic lending opportunities more aggressively, while the Bank of Cape Verde has started to sell central bank securities to absorb liquidity.

The buildup in official reserves has been supported by ongoing fiscal restraint. The overall fiscal deficit (including grants) was just over 5 percent of GDP in 2005: while higher than in 2004, the outturn for 2005 reflected an increase in the provision of concessional external loans and a delay in the disbursement of external grants. With the deficit financed in part by government asset sales, domestic debt declined to 33 percent of GDP at end-2005.

On the structural front, the government is moving forward with a range of reforms to improve public financial management and public administration. The government is also close to completing its privatization agenda, with TACV (the national airline) currently being restructured in preparation for its privatization and the bidding process getting under way for ENAPOR (the port operator). An important step in addressing the long-standing financial difficulties facing Electra (the electricity and water company) was the increase in electricity and water tariffs (by 25.4 and 13.3 percent, respectively) as of

June 1, 2006, following the government's decision to eliminate fuel subsidies in the 2006 budget. The independent economic regulatory agency has also signaled its commitment to fully implement an automatic mechanism to adjust these tariffs to reflect changes in input costs and provide incentives for efficiency improvements.

Executive Board Assessment

Directors recognized that the government's economic strategy has been anchored by a build-up in international reserves that has strengthened the exchange rate peg to the Euro; improvements in the fiscal position despite election pressures; and progress in privatization and other structural reforms.

Directors observed that Cape Verde's strengthened macroeconomic stability and policy credibility have supported solid economic growth and sound development prospects. They commented in particular on the pickup in foreign direct investment over recent years, along with the strong outlook for investment, especially in tourism and infrastructure. However, while medium-term prospects are favorable, Directors noted that Cape Verde remains vulnerable to external shocks and dependent on foreign aid and remittances.

Directors agreed that the policy priority is to work to accelerate growth within a stable macroeconomic environment. Key requirements are to safeguard the exchange rate peg, contain fiscal risks, and improve management in the public sector. They concurred that the fixed exchange rate has served Cape Verde well—noting the favorable evolution of the real exchange rate and exports, and they welcomed the focus on increasing foreign exchange coverage in support of the exchange rate peg.

Directors lauded the authorities' commitment to fiscal restraint to help address pressures that may arise over the long term from public pension liabilities, a growing demand for public services, and a decline in concessional external support. They welcomed the authorities' plans to create fiscal space by reducing domestic debt as a share of GDP, rationalizing the current system of tax exemptions, and better prioritizing public spending. Directors also emphasized the importance of the measures taken in the 2006 budget to eliminate fuel subsidies and clear arrears, and noted that containing the wage bill will be essential for achieving budget objectives.

Directors agreed that the authorities' macroeconomic objectives will be supported by measures to improve public sector management, especially in drawing up and executing budgets, and reforming the civil service to increase capacity and productivity. They endorsed the attention to public sector and regulatory reform, and urged the authorities to complete the privatization agenda and push ahead with measures to improve the business environment.

Directors noted the recent energy sector developments that have resulted once again in the state's acquisition of a majority shareholding in Electra. They emphasized the need to avoid fiscal risks from this source and called on the authorities to ensure that Electra is run on commercial terms and under a regulatory framework that will support much needed investment in electricity and water supplies. Directors strongly supported Cape Verde's commitment to ensuring that financial sector development, especially in the rapidly growing offshore financial center, takes place under institutional and regulatory conditions that are in line with international best practice. Implementing the AML/CFT legislation will be important, as well as criminalizing terrorist financing in line with the UN Convention.

In welcoming the PRSP annual progress report, Directors encouraged the authorities to continue pursuing reforms consistent with the PRSP pillars. They urged implementation of the recommendations of the Joint Staff Advisory Note, including on improving the quality of primary education, access to health services, and the scope and timeliness of data for monitoring the PRSP.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Cape Verde: Selected Economic and Financial Indicators, 2002–06

	2002	2003	2004	2005	2006 Proj.
	(Percentage change unless otherwise stated)				
National accounts and prices					
Real GDP	5.3	4.7	4.4	5.8	5.5
Real GDP (per capita)	3.4	2.8	2.5	3.8	3.5
Consumer price index (annual average)	1.9	1.2	-1.9	0.4	6.2
Gross capital formation (percent of GDP)	35.8	31.0	36.8	37.9	38.7
Gross national savings (percent of GDP)	24.4	20.0	22.4	33.3	31.8
Money and credit					
Net foreign assets	18.6	-7.7	31.9	58.8	19.0
Credit to nongovernment	12.0	15.2	9.3	9.2	13.7
Broad money (M2)	14.3	8.6	10.5	15.5	13.6
Central government					
Total revenue (percent of GDP)	22.9	22.0	23.2	24.1	25.1
Total grants (percent of GDP)	8.7	5.5	10.9	7.1	9.0
Total expenditure (percent of GDP)	34.4	31.1	36.1	36.3	41.2
Overall balance (including grants, percent of GDP)	-2.9	-3.5	-2.0	-5.1	-7.1
External debt (percent of GDP)	56.4	57.5	54.0	55.4	52.4
Net domestic debt (percent of GDP)	29.2	27.3	35.0	32.7	27.2
External					
Exports of goods and services (local currency)	14.1	6.1	5.2	20.5	8.9
Imports of goods and services (local currency)	15.3	7.5	6.5	0.5	14.6
Real effective exchange rate (annual average)	0.5	1.8	-2.9	-2.1	...
Overall balance of payments (percent of GDP)	6.3	-0.7	4.1	5.7	2.2
Current account balance (including current grants, percent of GDP)	-11.4	-11.1	-14.4	-4.6	-6.9
Gross reserves (months of prospective imports)	1.9	1.7	2.4	3.0	3.1
External debt service (percent of exports)	12.4	10.5	11.3	8.8	8.2

Sources: Cape Verdean authorities, and staff estimates and projections.

Press Release No. 06/172
FOR IMMEDIATE RELEASE
August 1, 2006

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves a Three-Year Policy Support Instrument for Cape Verde

The Executive Board of the International Monetary Fund (IMF) has approved a three-year Policy Support Instrument (PSI) for Cape Verde under the IMF's newly created PSI framework, which is intended to support the nation's economic reform efforts.

Cape Verde's PSI is designed to enhance the sustainability of growth and development by maintaining a stable macroeconomic environment and moving forward with structural reforms. Specific attention is given to reducing fiscal risks and giving Cape Verde a margin of safety to protect the economy against exogenous shocks. Approval of a PSI for Cape Verde signifies IMF endorsement of the policies outlined in the program.

The IMF's framework for PSIs is designed for low-income countries that may not need, or want, IMF financial assistance, but still seek IMF advice, monitoring and endorsement of their policies. PSIs are voluntary and demand driven. PSI-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners and articulated in a Poverty Reduction Strategy Paper (PRSP). This is intended to ensure that PSI-supported programs are consistent with a comprehensive framework for macroeconomic, structural and social policies to foster growth and reduce poverty. Members' performance under a PSI is normally reviewed semi-annually, irrespective of the status of the program. (see Public Information Notice No. 05/145).

Following the Executive Board's discussion of Cape Verde, on Monday, July 31, 2006, Mr. Agustín Carstens, Deputy Managing Director and Acting Chair, said:

"Cape Verde's economic and policy performance remains sound. GDP growth is estimated to have reached nearly 6 percent in 2005, supported by strong private and public investment. The favorable investment outlook—especially in tourism and infrastructure development—bodes well for growth in the years ahead. While inflation has picked up recently, influenced by temporary increases in food prices and higher international oil prices, it is expected to fall sharply over the coming year.

"Underpinning Cape Verde's positive economic climate, the government has shown a clear commitment to maintain prudent macroeconomic policies and push ahead with structural reforms. Key support for growing policy credibility has come from the build-up of foreign exchange rate reserves to back the fixed exchange rate peg to the euro; from improvements in fiscal discipline; and from progress with privatization and other measures to improve economic efficiency and reduce fiscal risks.

“The priorities in the program supported by the three-year Policy Support Instrument are to further increase foreign reserve coverage and create fiscal space in anticipation of possible pressures on public spending or financing. Specific measures include reducing domestic debt as a share of GDP, rationalizing tax exemptions, and better prioritizing public spending.

“The new program also emphasizes public sector and regulatory reforms. Particular attention will be given to strengthening public sector financial management and civil service capacities; improving the regulatory framework for the energy sector, including through full implementation of the tariff adjustment mechanisms for electricity and water; and ensuring that financial sector development, especially in the rapidly growing offshore financial sector, takes place in line with international best practice,” Mr. Carstens said.

ANNEX

Recent Economic Developments

Cape Verde's economic and policy performance has strengthened significantly in the recent years, supported by reforms pursued under the country's first Poverty Reduction and Growth Facility (PRGF) arrangement. International reserves have increased, adding credibility to the exchange rate peg to the euro. The fiscal position has improved and, in a marked break from the past, fiscal restraint held firm through the recent elections. Privatization and other structural reforms are moving ahead. Reflecting the improved policy environment, growth has averaged around 5 percent since 2000, supported by strong inflows of external financing from both private and official sources.

Program Summary

Cape Verde's program under the PSI aims to provide a consistent and coherent economic policy framework to underpin the Government's medium-term development objectives. Key policy measures in the program include:

- Increasing foreign exchange coverage to strengthen further the credibility and resilience of the exchange rate peg;
- Decreasing the burden of domestic debt and clearing remaining domestic arrears;
- Strengthening public finance management capacity, expenditure control, and revenue performance;
- Pursuing structural reforms to reduce fiscal risks and support efficiency improvements in the economy;
- Regulatory reforms to ensure that financial sector development takes place within a sound institutional framework

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	(Percentage change unless otherwise stated)				
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Sources: Cape Verdean authorities, and staff estimates and projections.

Statement by Damian Ondo Mañe, Executive Director for Cape Verde
July 31, 2006

I. Introduction

On behalf of my Cape Verdean authorities, I would like to thank staff for the constructive policy dialogue and candid exchanges during the discussions held in Praia. My authorities are of the view that the staff report is accurately informative of the challenges they face and the commitment of the authorities to the reform agenda.

Since 2001, the authorities have been implementing a strong reform program in order to correct severe imbalances in the economy, raise economic growth and reduce poverty. The reform program was consistent with the country's medium-term development goals as articulated in the authorities' PRSP.

The authorities have made good progress in the implementation of the program. Macroeconomic policies have been broadly consistent with the objective of achieving stability and reducing the economy's vulnerability to external shocks. All quantitative performance criteria were met and poverty was drastically reduced so much as to propel Cape Verde out of the low income countries group. These achievements enabled Cape Verde to become one of the first group of countries to qualify for U.S. assistance under the Millennium Challenge Corporation which puts a strong premium on governance and soundness of the country's policies.

The authorities are very grateful to the Fund for its advice and support, and welcome a continued close policy dialogue. However, as Cape Verde does not need Fund financial assistance presently, but want to continue the reform program to strengthen the country's economic and policy performance, the authorities are requesting a PSI arrangement, the details of which are provided in their Letter of Intent, Memorandum of Economic and Financial Policies and the Technical Memorandum of Understanding. The authorities view the PSI as a suitable instrument to support their reform efforts. The significant improvement in the economic and financial situation is helping to move Cape Verde to the rank of middle income countries. The commitment to reforms and the progress achieved should also enable Cape Verde to rely more on the capital markets for its financial resources. However, the authorities have indicated that they will follow a very prudent approach as regards borrowing. Their intention, presently, is to bring down the debt ratio.

The program supported by the PSI aims at providing a consistent and coherent economic policy framework to underpin the Government's medium-term development objectives. More broadly, the program is designed to enhance the sustainability of growth and development by maintaining a stable macroeconomic environment and continuing with structural reforms. Through the PSI, the authorities seek a support to their development strategy as laid out in the PRSP whose goal is to reduce macroeconomic vulnerabilities to exogenous shocks, and address the prospect of a longer-term decline in highly concessional external support.

II. Recent Economic Development

Economic and policy performance continued to be strong in 2005. Real GDP growth was high, at almost 6% led by an increase in private investment in the tourism sector and a higher execution rate of public investment. Although inflation remained subdued overall since 2003, a spike was recently recorded due to temporary supply shocks in the food and energy sectors.

Fiscal discipline was maintained, despite the electoral cycle. Strong domestic revenues were collected from the divesture of governments financial and non financial assets. The authorities maintained a prudent stance with regards to spending, which enable them to reduce net domestic borrowing. Nonetheless, fiscal pressures appeared in 2005 due to a delay in the disbursement of a budget grant and the increase in the wage bill. The latter spending was required to hire and promote additional teachers and security personnel.

Monetary policy was geared towards the safeguard of the peg to the Euro. The external assets position of the country strengthened with the accumulation of reserves and non-energy inflation remained subdued. The stock of international reserves increased from 2.4 months of prospective imports in 2004 to 3 months in December 2005. The recent spike in inflation is related to a one time adjustment of energy prices paid by consumers to align them with the market prices. While my authorities remain vigilant to the risks of a pass-through of high oil prices which may reduce growth, they point out that these are temporary supply shocks and that there is ample margin for policy action to address these risks should they materialize.

The prudential indicators of the banking sector and financial services remained strong, and financial intermediation deepened. However, due to a large inflow of foreign exchange stemming from remittances, estimated at 40 percent of total deposits, and export growth, excess reserves of commercial banks increased. The Bank of Cape Verde, therefore undertook to sell securities in order to absorb the excess liquidity. The payment system was upgraded with the deployment of a network of automatic cash counters and the expansion of credit card services. The offshore financial sector grew rapidly also. In total the banking sector assets have grown by 20% since 2004 to reach 90 percent of nominal GDP.

My authorities have continued to implement the structural reform agenda. A new management team was selected to redress TACV in preparation for its privatization. The privatization of the port operator, ENAPOR is well under way. Overall, the government plan to complete in 2006 its privatization process with the sale or liquidation of the remaining four public companies.

An agreement was reached in the conflict between the government and the majority private shareholders of ELECTRA regarding tariff deficit that the government owed to the company because of subsidies to electricity and water. My authorities decided to eliminate the fuel subsidies starting in June 2006 and the price of water was adjusted upward to reflect market developments.

Other structural reforms were undertaken in relation to Cape Verde's impending WTO accession.

III. Macroeconomic and Structural Policies for the Medium Term

The medium-term strategy is consistent with the PRSP which is aimed at enhancing growth prospects and reducing poverty through private sector-led development and diversification of economic activities. The priorities are (i) improving human capacities; (ii) strengthening and developing infrastructure and institutions; and (iii) improving governance and the capacity of the public sector to implement policy reforms.

The medium-term strategy aims at preserving macroeconomic stability and addressing the economy's vulnerabilities to external shocks. The key objectives are raising the average economic growth rate to 6–7 percent in 2007–09, bringing the inflation rate to close to zero in 2007–08 and stabilizing it at 2–3 percent thereafter. The program also aims at increasing the level of international reserves by 0.1 months of imports per year, and lowering public debt to below 70 percent by 2009

Fiscal Policy and Public Sector Reforms

To meet the program's fiscal objectives, my authorities are committed to ongoing restraint of current spending, combined with structural reforms to improve revenue performance and improve financial management. In this regard, the authorities are taking steps to rationalize and streamline tax incentives and exemptions, implement an automatic mechanism for adjusting electricity and water tariffs, establish a macroeconomic policy unit at the Ministry of Finance to help in improving the formulation of fiscal policy and coordinating with overall macroeconomic objectives, and strengthen internal and external audit process. In addition, the government is committed to financing the public investment program primarily through concessional external loan.

Monetary and Financial Sector Policies Reforms

Monetary policy under the PSI will focus on preserving the exchange rate peg with the Euro. This policy provides a strong anchor to inflation expectations and a cushion against exogenous shocks for the benefit of investors. Under the PSI, the authorities plan to build up international reserves as noted above. Credit to the central government will be reduced thus allowing for an increase in credit to the private sector, which should support the development of private sector activities. Moreover, as emigrants deposits play such an important role in the economy, the central bank will move forward with the tracking of gross inflows and outflows of these deposits to support its analysis of the interest sensitivity of the flows. My authorities are committed to the strengthening of the operational framework for monetary policy and the modernization of the regulation and supervision of financial institutions. A task force has been organized by the BCV which will draft an Action Plan based on Fund advice.

Other Structural Reforms

Structural reforms will focus on improving the business climate and enhancing the competitiveness of the economy. Notably, my authorities have engaged discussions aimed at introducing more flexibility in the labor market; a modern regulatory framework has been drafted with a view of liberalizing the telecom market; and a modern information technology system is being deployed in the public service under the *e-government initiative* in order to remove administrative obstacle to the private sector. Moreover, trade reforms are being implemented and a decision on accession to the WTO is expected in 2006.

Program for 2006–07

Within the framework set forth by the medium-term plan the authorities plan to frontload the implementation of key measures during the 2006–07 budget cycle.

On **fiscal policy**, my authorities plan to strengthen revenue collection and management while rationalizing spending. They expect an inflow stemming from privatizations and land sale receipts which are projected to reach 3.7 percent of GDP. Further resources will be made available by the elimination of petroleum subsidies. These resources will be used to continue to reduce domestic debt to 25 percent of GDP by end-2007. A provision to significantly reduce arrears has been made and it is expected that one-third of the end-2005 stock of arrears will be cleared in 2006.

On **monetary policy** my authorities intend to take steps to strengthen the exchange rate peg to the Euro. The gross international reserves of the BCV are accordingly programmed to increase by CVESC 2.1 million in 2006 and 2.3 million in 2007, which represents 3.2 months of prospective imports. While ceilings on the growth of domestic assets will be implemented, the BCV will enhance its analysis and tracking of emigrant deposits inflows and outflows.

The strengthening of the financial sector is also a key priority that the authorities wish to address by 2007. The policy action will be informed by the ad-hoc task force recommendations. In priority, BCV's capacity to conduct surveillance and the regulations of IFI's will be enhanced.

IV. Conclusion

Cape Verde's economic and financial performance has improved significantly in the recent past supported by a PRGF arrangement. Nevertheless, Cape Verde continues to remain vulnerable to exogenous shocks and the country still faces important development challenges. To address the challenges, my authorities are determined to further the reform agenda in close collaboration with the Fund and other development partners, so that Cape Verde can move up the economic ladder and be soon among the emerging market economies. My authorities are confident that this can be achieved. To help them implement their ambitious program of reform, the authorities are requesting Fund support under a PSI. In view of their commitment and full ownership of the program and their excellent past policy performance, I request the support of Directors for my Cape Verdean request.