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Cape Verde: Third Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver and Modification of Performance Criteria—Staff Paper; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Cape Verde

In the context of the third review under the three-year arrangement under the Poverty Reduction and Growth Facility and request for waiver and modification of performance criteria, the following documents have been released and are included in this package:

- the staff report for the third review under the three-year arrangement under the Poverty Reduction and Growth Facility and request for waiver and modification of performance criteria, prepared by a staff team of the IMF, following discussions that ended on **October 15, 2003,** 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 December 3, 2003**. 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 Press Release summarizing the **views of the Executive Board as expressed during its December 19, 2003 discussion** of the staff report that completed the request and/or review.

- a statement by the Executive Director for Cape Verde.

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

Letter of Intent sent to the IMF by the authorities of Cape Verde*
Memorandum of Economic and Financial Policies by the authorities of Cape Verde*
Technical Memorandum of Understanding*

*May also be included in Staff Report

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

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CAPE VERDE

Third Review Under the Three-year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver and Modification of Performance Criteria

Prepared by the African Department

(In consultation with other Departments)

Approved by Menachem Katz and Anthony Boote

December 3, 2003

- **PRGF arrangement.** A three-year PRGF arrangement for SDR 8.64 million (90 percent of quota) was approved by the Executive Board on April 10, 2002. Three loans totaling SDR 3.69 million have been disbursed, and another SDR 1.23 million becomes available at the completion of this review.
- **Developments.** Economic performance in the first half of 2003 was weaker than expected, but a rebound in the second half of 2003 is expected to result in real GDP growth of 5 percent and inflation of 2 percent for the year as a whole, in line with the program. A revenue shortfall led to the nonobservance of three quantitative performance criteria for end-June 2003. With a tightening of monetary policy and actions to improve tax yields, the authorities are requesting waivers for June and a modification of the end-December limit on net bank credit to the government. They also request a modification of the performance criterion on nonconcessional borrowing to allow for two OPEC Fund loans. The overall fiscal deficit (including grants) is projected at 4 percent of GDP in 2003 (compared with a programmed 2 percent) and will be largely covered by net external financing.
- **Letter of intent and memorandum on economic and financial policies.** The authorities reaffirm their commitment to the fiscal and monetary restraint needed to sustain the peg, as well as measures to strengthen antipoverty programs and enhance international competitiveness.
- **Discussions.** During September 30–October 15, 2003, the staff team met with Prime Minister José Maria Neves, Finance Minister Carlos Burgo, Governor Olavo Correira of the Bank of Cape Verde, and other officials and private sector representatives.
- **Staff.** The team comprised Mr. Rogers (Head), Messrs. Camard, Roy, and Laporte, and Ms. da Luz (Research Assistant) (all AFR).
- **Documentation.** The principal authors of this staff report are W. Scott Rogers and Tobias Roy.

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I. Introduction

1. **On April 10, 2002, the Executive Board approved Cape Verde's request for a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF), in the amount of SDR 8.64 million (90 percent of quota), to support the authorities' economic program for January 2002–December 2004.** On the same occasion, the Executive Board approved Cape Verde's interim poverty reduction strategy paper (I-PRSP) (www.imf.org), as did IDA shortly afterward. The first review under the PRGF arrangement was concluded on December 16, 2002, together with the 2002 Article IV consultation. The second review was concluded on June 25, 2003, at which time Executive Directors concluded that Cape Verde's PRSP preparation status report provided a sound basis for Fund concessional assistance.

2. **In the attached letter dated December 2, 2003 (Appendix IV), and the attached supplementary memorandum on economic and financial policies (MEFP, Appendix IV, Attachment I), the government of Cape Verde requests the completion of the third PRGF review, waivers for the nonobservance of three quantitative performance criteria, and modification of two quantitative performance criteria.** In support of these requests, the supplementary MEFP reviews progress made during 2003 and sets forth policies to be implemented through June 2004. Progress will be monitored by quantitative performance criteria for end-December 2003 and end-June 2004, as well as structural performance criteria and benchmarks through June 2004. A fourth disbursement of SDR 1.23 million is being requested, conditional on the completion of the third review. Cape Verde's reform effort is also being financed by the World Bank, the African Development Bank (AfDB), the European Union (EU), and other bilateral and multilateral development partners.

II. Recent Economic and Policy Developments

3. **Economic growth was weaker than expected in the first half of 2003, reflecting the recession in Portugal and the impact of international security and health concerns on tourism.**[1] A strong rebound in agriculture and a strengthening of export demand and tourism in the second half of the year are expected to result in real GDP growth of 5 percent for the year as a whole, in line with the program (Table 1 and Figure 1).[2] The exchange rate peg to the euro has helped contain inflation at 2 percent. Cape Verde's real effective exchange rate has appreciated recently (Figure 2), mirroring the appreciation of the euro against the U.S. dollar, but the current level is in line with the average rate of the past five years and remains competitive.

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[1] Portugal is the destination for 90 percent of Cape Verde's manufactured exports and is a major source of tourism receipts.

[2] However, the composition of GDP will be different, weighted more toward agricultural production. As a result, the effective tax base (i.e. nonagriculture GDP and imports) will be lower than programmed.

4. **A revenue shortfall in the first half of 2003 amounting to 2 percent of GDP led to the nonobservance of three quantitative performance criteria.** Revenues were lower across most categories, reflecting weak economic activity (Table 2).[3] Expenditure savings were not sufficient to offset this shortfall, and the additional financing requirement was met by drawing down government deposits at the Bank of Cape Verde (BCV). The BCV did not sterilize the liquidity injection, and the resulting expansion in domestic credit intensified pressures on the balance of payments (Tables 3 and 4). These developments led to the nonobservance of the end-June performance criteria on net bank credit to the government, net domestic assets of the BCV, and net international reserves.[4]

5. **The authorities took corrective measures to address these slippages prior to the mission's arrival.** To enhance tax yields, they increased penalties for late payment of taxes and assigned the Directorate General for Assessment and Taxes (DGCI) a share of the tax penalties it collects. They also eliminated the interest rate subsidy on emigrant deposits.[5]

6. **Expenditure restraint, coupled with more nonbank financing than projected, enabled the authorities to observe the end-September indicative target on net bank financing.** The fiscal deficit (including grants) for the first nine months of the year was 2½ percent of GDP, against a programmed 1½ percent. About one-half of the additional deficit was financed by higher disbursements of external loans for capital projects. Nonbank financing was provided by INPS, the social security institution, increasing its holdings of treasury bills.

7. **Monetary policy was looser than programmed through most of the first nine months of 2003.** Reserve money increased by 10 percent during the 12 months ended September, against a projected 8¼ percent. This liquidity injection fueled credit growth and pushed net domestic assets of the banking system up by 10¾ percent of beginning-period broad money. It also led to a decline in net foreign assets of the banking system equivalent to 2½ percent of broad money, compared with a projected modest increase (Figure 3). Net international reserves have generally

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[3] Technical factors were also important, accounting for about one-half of the shortfall relative to GDP. These were an upward revision in nominal GDP, a delay in the collection of international trade tax arrears (which were not collected until the third quarter), and a shortfall in domestic capital participation (a notional amount for private sector contributions to public investment projects). The upward revision in nominal GDP in 2003 reflects the impact of revised estimates of real GDP growth in 2001-02 made jointly by the mission and the authorities.

[4] Net international reserves fell by €1.3 million during the first six months of the year, against a programmed accumulation of €0.3 million. The stock of reserves at end-June was €71 million.

[5] The subsidy was one percent a year on emigrant time deposits. These are local currency deposits financed by capital inflows from Cape Verdeans living abroad. They can be used for local or external current account transactions. Interest rates on emigrant time deposits averaged 7 percent at end-September 2003 (including the subsidy). The capital inflow used to open these accounts can be reversed only with authorization from the central bank.

been below targeted levels during the year, and the end-September indicative target was met only because one large bank sold foreign exchange to the BCV at the end of the month. The commercial bank repurchased foreign exchange from the BCV in early October, leaving net international reserves about €12 million below the end-December 2003 target.

8. **Structural reforms have generally progressed well, and all structural performance criteria and benchmarks through October were observed.**[6] The authorities have made impressive progress in reducing financial losses in government-owned enterprises.[7] The financial position of the TACV has improved substantially in 2003 as a result of its dropping unprofitable international routes, replacing high-cost aircraft with more efficient lease aircraft, and reducing the number of staff. The 2003 program contains a temporary subsidy to Electra of 0.4 percent of GDP. Actual payments were only 0.1 percent of GDP through September, and no further payment is envisaged this year. However, the government paid unprogrammed subsidies totaling 0.3 percent of GDP to other state-owned enterprises early in the year: the TACV; Interbase (the fish-freezing plant); and Arca Verde (the interisland maritime transport service). The government made slower progress in a few other areas: a comprehensive assessment of the stock of verified domestic arrears has not been completed; quarterly accounts of central government fiscal operations are not yet being reported to the National Assembly; and the review of tax exemptions has been delayed.

9. **The BCV has made good progress in implementing the recommendations by the safeguards assessment report (SAR).** An internal auditing function has been created, and the internal auditor has taken up his responsibilities. The external auditing contract has been rotated to a new auditing firm of good international standing. Front- and back-office functions of foreign exchange management have been physically separated, and the Bank of Portugal is providing technical assistance on related procedures. The new Fiscal (audit) Board has been established, strengthening internal control systems. The 2002 audited accounts have been published, and progress has been made toward implementing International Accounting Standards (IAS) in accounting and financial reporting. The BCV also issued regulations in the context of the law on money laundering to allow the authorities to seize assets of suspected terrorists.

III. Report on the Discussions

10. The discussions focused on (i) the realignment of fiscal and monetary policies to ensure that the targeted modest increase of international reserves in 2003 is met without interrupting the implementation of the government's poverty reduction strategy; (ii) the broad elements of the macroeconomic framework for 2004; and (iii) the implementation of structural reforms to reduce the need for subsidies to public enterprises and enhance international competitiveness.

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[6] See para. 7 and Table 2 of the MEFP.

[7] Electra (the partially government-owned electricity and water utility) and TACV (the wholly government owned national airline) had combined losses in 2002 equal to about 3.5 percent of GDP.

A. The Macroeconomic Framework and PRSP Process

11. **The mission and the authorities agreed that the macroeconomic framework for 2003-05 set forth in the previous MEFP remained broadly appropriate: real GDP growth on the order of 5–7 percent; inflation of 2–3 percent; and an increase in gross international reserves to the equivalent of 2½–3 months of imports of goods and services.** Broad money is projected to grow in line with nominal GDP, and credit to the economy somewhat more rapidly. The fiscal deficits projected for the medium term are consistent with declining external and domestic debt burdens. The 2004 program envisages real GDP growth of 5 percent, inflation of 2 percent, and an increase in international reserve coverage from 2.2 to 2.4 months of imports of goods and services.

12. **The mission met with the Steering Committee of the PRSP, which includes representatives from key line ministries, labor unions, the private sector, and nongovernmental organizations.** The committee indicated that it intended to complete a first draft of the PRSP by the end of the year and to finalize the document by end-March 2004. Committee members expressed concern that delays in completing the PRSP could slow the disbursement of donor flows. The mission acknowledged this, but encouraged the committee to take the time to produce a high-quality document that adequately reflected the participation of key stakeholders, fully costed key government policies, discussed progress toward the Millennium Development Goals, and was consistent with accelerating economic growth and poverty reduction, while preserving macroeconomic stability.

B. Fiscal Policy

Policies for 2003

13. **The discussions on fiscal policy focused on the appropriate response to the revenue shortfall.** The authorities expressed the view that, in light of the variety of recent and pending revenue measures, increasing tax rates at this time, or in the context of the 2004 budget, would be undesirable—a view shared by the mission.[8] While the measures to enhance tax yields were expected to take effect fairly quickly, the mission recommended that expenditure policy in the fourth quarter be based on a cautious revenue outlook, an approach accepted by the authorities. Thus, domestic revenue is projected to be 21.7 percent of GDP for the year, compared with a programmed 24.5 percent.[9] The authorities indicated that it would be very difficult to maintain

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[8] Domestic retail petroleum prices were raised twice in 2001, the customs user fee was raised in 2002, electricity and water tariffs were increased substantially in January 2003, and the value-added tax (VAT) and new customs tariffs become effective January 1, 2004, as does the new corporate income tax rate, which was lowered from 35 percent to 30 percent in the 2003 budget law.

[9] As in the first half of the year, about half of the shortfall relative to the program reflects the combined effects of the upward revision of nominal GDP (see footnote 3) and the downward

(continued)

the fiscal stance of the first nine months of the year into the fourth quarter without interrupting the recruitment of new teachers and doctors for the upcoming year. Nonetheless, domestic expenditure would still be lower than programmed because of smaller obligations for dismissed public enterprise workers and for counterpart funding of capital projects.

14. **The overall fiscal deficit (including grants) is projected at 4.1 percent of GDP, against a programmed 2.0 percent.** Net external financing would nearly cover the deficit, and domestic financing would be on the order of 0.2 percent of GDP. While the domestic borrowing requirement will remain low, additional bank financing amounting to 1 percent of GDP would be needed, given the programmed reduction in domestic arrears. To meet this additional financing requirement, the authorities are requesting a modification of the end-December performance criterion for net bank credit to government by CVEsc 0.8 billion. The ratio of government domestic debt to GDP will continue to fall even with this upward modification.

Policies for 2004

15. **The discussions on the 2004 budget centered on striking a balance between the authorities' desire to move ahead with priority spending and ensuring that the stance of fiscal policy is supported by a financing strategy that would allow an increase in net international reserves and that would be consistent with adequate growth in credit to the economy.** Revenue is projected to fall relative to GDP (to 21 percent), reflecting the one-off effect of tax arrears collections in 2003 and the impact of the lower corporate income tax rate that becomes effective January 1, 2004. Total expenditure is being capped at 32 percent of GDP.[10] The deficit would be nearly covered by net official flows, and the balance would come from domestic nonbank sources.[11] The financing gap for 2004 is projected at €26 million (3.3 percent of GDP). About €20 million in potential foreign assistance has been identified, of which €9 million would be in the form of grants. The prospects for closing the financing gap for the second half of the year are good, once the authorities have completed the PRSP. The program is fully financed through end-June 2004.

16. **A continuation of recent fiscal trends in the medium term will make it difficult to sustain the exchange rate peg without additional donor budget support, preferably in the**

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revision of domestic capital participation. The remainder of the shortfall reflects a re-estimate of the composition of GDP (see footnote 2).

[10] The authorities submitted a draft 2004 budget to the National Assembly that is consistent with understandings reached during the mission.

[11] In the new projection for 2004, clearance of domestic arrears has been revised downwards from 0.4 percent of GDP to zero, as the government will have regularized its financial position with oil companies and other suppliers by the end of 2003. The government indicated that all remaining domestic arrears will either be rescheduled or cleared by issuing government securities.

form of grants. While the primary domestic balance will still register a surplus in 2004, it will shrink for the second consecutive year. A key contributing factor is the rapidly growing wage bill, which reflects the hiring of new teachers to serve the growing cohorts of students (and, to a lesser extent, the hiring of new doctors). As a result, recurrent expenditures grew twice as fast as revenues in 2003 and are expected to do the same in 2004. The mission impressed upon the authorities the importance of ensuring, in the medium term, that the pace of implementation of their poverty reduction strategy did not exceed available resources. In this context, the mission reiterated the importance of the PRSP as the mechanism for setting forth clear strategies for education and health care and identifying the necessary budget support. If adequate support is not forthcoming, the authorities will need to slow the pace of hiring new teachers and doctors, reduce other recurrent outlays, or increase revenues. The authorities will need to set forth their preferred strategy for responding to this contingency in their forthcoming PRSP.

17. **Regarding fiscal reforms, the authorities indicated that they were on schedule for implementing the value-added tax (VAT) and new customs tariffs on January 1, 2004.** FAD has stepped up its technical assistance during October-December to help ensure a smooth transition. The authorities noted that technical difficulties with the revenue- and expenditure-tracking system prevented them from submitting quarterly accounts of fiscal operations to the National Assembly, as had been envisaged. These difficulties are being resolved with technical assistance, and the authorities intend to begin submitting quarterly reports by end-June 2004 (a structural benchmark under the proposed program). After some delay, the authorities will also complete a comprehensive assessment of tax exemptions, with a view to reducing their number in the medium term and thus helping ensure the buoyancy of the tax base. This project is being financed by the World Bank under the Growth and Competitiveness Project, and its completion by end-June would be a structural benchmark.

C. Monetary Policy

18. **The discussions on monetary policy centered on the appropriate response to the slower-than-expected accumulation of international reserves and the need for additional bank financing of fiscal operations in the fourth quarter of 2003**. The monetary authorities reaffirmed their commitment to orient monetary policy toward the accumulation of international reserves, which they recognized as indispensable to sustaining the peg and improving market confidence. They agreed with the mission's assessment that monetary policy needed to be tightened quickly to ensure that their modest target for accumulation of international reserves in 2003 could be achieved, and that this tightening should continue until there were clear signs of a sustainable upward trend in international reserves. The BCV increased the minimum reserve requirement from 18 percent to 19 percent effective October 27, which would mop up the equivalent of about €5 million in bank liquidity.[12] In addition, the BCV began issuing central

[12] Required reserves are not remunerated.

bank bills on November 11 to further tighten monetary conditions.[13] As a consequence of this tightening and the provision of additional domestic bank credit to the government, credit to the economy is projected to grow at an annualized rate of 5 percent in the fourth quarter, after growing at an annualized rate of 15 percent during the first nine months of the year. The growth rate of credit to the economy for the year as a whole, however, would be about 12 ½ percent, in line with the program.

19. **For 2004, broad money is projected to increase by about 8 percent, in line with nominal GDP**. The assumption of constant money velocity is subject to some uncertainty. Velocity fell an average of 5 percent a year during 1999-2002, reflecting the growing importance of emigrant deposits as a source of broad money growth. Nonetheless, the authorities and the mission agreed that it is a reasonable and prudent assumption and is consistent with the cautious outlook for the growth of emigrant deposits. Credit to the economy would grow by about 12 percent (6 percent of beginning-period stock of broad money), and net bank credit to government would be close to zero. Gross international reserves would increase by at least €13 million, raising reserve coverage to 2.4 months of imports of goods and services.

D. Program Debt Limits and External Debt Sustainability

20. **The authorities are requesting a modification of the ceiling on nonconcessional debt to allow them to move ahead with two loans by the OPEC Fund for International Development, amounting to US$10 million, that do not meet the minimum 35 percent grant element under the program.** The authorities have negotiated, but not yet signed, these loans, which are for the construction of schools and health facilities in remote rural areas. The grant element of the loans is estimated at 29 percent. The authorities indicated that this was the maximum concessionality the OPEC Fund was prepared to offer, and that alternative highly concessional sources of finance could not be found. The attached debt sustainability analysis (Appendix III) indicates the net present value (NPV) of debt-to-exports ratio was 140 percent at end-2002 and that, under reasonable assumptions regarding new borrowing and export growth, Cape Verde's debt burden will continue to ease in the coming years even with these loans. On this basis, and given the importance of the proposed projects to the poverty reduction strategy, the mission informed the authorities that it would support the contracting of these two loans.

E. Private Sector Development and Structural Reforms

21. **The authorities have begun implementing a comprehensive Growth and Competitiveness Project, with financial and technical assistance from the World Bank.** The project covers reforms in the (i) pension system; (ii) investment climate (including tax reform, the alleviation of administrative barriers, the development of supply chains, and the strengthening of the legal environment); (iii) privatization and regulation (including banking supervision); and (iv) institutional and private sector capacity building.

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[13] The BCV intends to reduce the reserve requirement over time as it uses central bank and treasury bills more frequently for liquidity management.

22. **The discussions on structural reforms focused on reducing or eliminating the need for budgetary subsidies to wholly and partially government-owned enterprises.** The authorities indicated that there may be a need for "minimum service" subsidies in key sectors (notably transportation) to ensure that basic services were provided to remote locations that would not otherwise be served. The mission accepted this principle, but indicated that such subsidies should be part of a well-articulated and comprehensive sector strategy, which should be included in the PRSP, and that these subsidies should be capped and explicitly included in the budget.

Public utilities

23. **The mission urged the authorities to commit themselves to not pay a subsidy to Electra in 2004, noting that the government had already done a great deal to improve Electra's financial position.** However, the government signed an agreement with the company in July 2003 stating that it would pay a subsidy to help defray production costs in remote diesel-fueled facilities. The authorities are finalizing their assessment of the adequacy of current electricity and water tariffs with support from the World Bank and, on this basis, will determine if any additional subsidy would be paid in 2004. To ensure transparency and accountability, it was agreed that, as a continuous performance criterion under the program, no subsidy would be paid until an additional memorandum of understanding had been signed with Electra that clearly identified the qualifying facilities and that stated that subsidies would be paid only after the government confirmed the level of fuel consumption in these facilities. If it is determined that a subsidy is needed, the authorities will offset this outlay by reducing other nonpriority expenditures.

24. **The creation of the Economic Regulatory Agency (ARE) is an important step toward ensuring that electricity and water tariffs are adjusted in response to changing costs of production, while, at the same time, encouraging greater efficiency by Electra.**[14] In close consultation with World Bank staff, the mission urged the authorities to move quickly to make the agency operational and to make tariff regulation one of its priorities. Thus, it was agreed that, as a structural benchmark under the program, the ARE would approve a methodology for determining electricity and water tariffs by end-June 2004.

Privatization

25. **Three other enterprises that drew upon budget resources to cover operating losses in 2003 are being prepared for privatization with financial and technical assistance from the World Bank.** With regard to the TACV, the government intends to engage a specialized international management team that will (i) implement TACV's operational restructuring (including staff reductions); (ii) design a development strategy for the airline; (iii) identify international partners and networks; and (iv) initiate privatization negotiations. Six potential

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[14] The ARE will have responsibility for price regulation in energy, water, telecommunications, and urban and maritime passenger transport.

investors have shown interest in Interbase, and the privatization is expected to be completed by June 2004. The government revised the privatization law in June 2003 to reflect the new strategy for liquidating Arca Verde's shipping fleet, and it is expected to decide shortly on a minimum service subsidy for remote and underserved islands.

F. Program Monitoring

26. The proposed quantitative and structural performance criteria and benchmarks through June 2004 are specified in Tables 1 and 3 of the MEFP (Appendix IV, Attachment I). The definitions of relevant terms and the specification of reporting requirements are contained in the amended technical memorandum of understanding (TMU, Appendix IV, Attachment II). The staff expects to hold discussions on the fourth review by April 2004. The fourth review will focus on measures to close the financing gap for the second half of 2004 and on structural reforms to enhance international competitiveness and private sector development.

IV. Staff Appraisal

27. **It is unfortunate that the end-June 2003 performance criteria were not met, but the staff commends the authorities for taking corrective actions and for their commitment to maintain the pace of structural reforms.** Economic growth remains strong, inflation continues to be low, the prospects for further accumulation of international reserves is good, and progress is being made in establishing conditions for higher rates of private sector-led economic growth. All structural performance criteria and benchmarks through October 2003 were observed, and the authorities have addressed the program slippages of the first half of the year.

28. **The stock of international reserves remains too low to provide an adequate buffer against recurrent shocks, and the accumulation of reserves during the first nine months of 2003 was generally slower than envisaged.** The staff reiterates the importance of orienting monetary policy toward a continued accumulation of international reserves. It therefore welcomes the recent tightening of monetary policy, which is necessary to meet the end-December international reserve target and to maintain confidence in the exchange rate peg.

29. **The staff concurs with the authorities' proposed macroeconomic policy mix for 2003-04.** It strikes an appropriate balance between the need to move ahead with implementing the poverty reduction strategy and the need to ensure adequate fiscal support for the accumulation of international reserves. The program for 2004 allows for the continued expansion of education and health services, an increase in international reserve coverage, and adequate growth in credit to the economy. Attaining these objectives will require budget support from Cape Verde's development partners.

30. **The authorities are urged to prepare a quality PRSP as quickly as possible**. This will provide them with the opportunity to prioritize and cost their policies, and ensure that the level of public spending is consistent with accelerating economic growth and poverty reduction, while preserving macroeconomic stability. It will be particularly important for the authorities to set clear and attainable targets for expenditures in public education and health, given the dominance of these sectors in the central government wage bill.

31. **Given the importance of the two OPEC Fund loans to the authorities' poverty reduction strategy, the relatively large grant element of the loans, and the good prospects for the government's external debt dynamics, the staff supports the authorities' intention to move ahead with these two loans.** However, the staff encourages the authorities to make every effort to limit future external debt financing of their poverty reduction strategy to grants and highly concessional loans in order to increase poverty-reducing expenditures without endangering external debt sustainability.

32. **The staff welcomes the progress made in preparing to implement the VAT and the new customs tariffs on January 1, 2004.** The National Assembly and the Council of Ministers have passed all the necessary laws and decrees, and indications point to a smooth transition. The VAT and new customs tariffs will enhance tax buoyancy and export competitiveness. The staff urges the authorities to complete the study on tax exemptions and submit a plan to reduce them significantly with the 2005 budget. It also strongly encourages them to begin submitting quarterly reports of fiscal operations to the National Assembly in order to improve transparency and accountability and to better inform the national debate on economic policy.

33. **Progress in implementing other structural reforms and reducing financial losses in public enterprises has been impressive.** Making the new Economic Regulatory Agency fully operative will be essential to ensuring the profitability and efficiency of public utilities, which, in turn, will be key to reducing the need for budgetary support and promoting private sector growth. The staff recognizes that there could be a need for subsidies in some cases to ensure the provision of a minimum level of service to vulnerable households. However, these subsidies should be well targeted, limited, part of a comprehensive sector strategy, and explicitly included in the government budget. The staff looks forward to the authorities' progress in this area with support from the World Bank.

34. **The policy slippages in 2003—albeit disappointing—should be seen against the authorities' strong track record of pursuing prudent fiscal and monetary policies while redirecting public expenditures toward key social services.** On the basis of this record, the corrective measures already taken, and the policies set forth in the supplemental MEFP, the staff recommends the approval of the authorities' request for waivers and modification of performance criteria.

Box 1. Providing Public Services Efficiently in Cape Verde

Private sector-led growth and the diversification of the economy form a core element of the authorities' economic strategy. To achieve these goals, it is vital that critical business services be provided in an effective and efficient manner. This was one of the motivations behind the privatization program, which saw large numbers of state-owned enterprises sold during the 1990s. In key sectors, however, the results have not been as successful as had been hoped, and dominant enterprises have been impediments to the takeoff of the economy. Many of these impediments are being addressed in a large Growth and Competitiveness Project, for which World Bank funding became effective in October 2003. The principle sectors in which progress is needed are the following:

- **Public utilities**. Electricity throughout Cape Verde, and water and waste treatment on the larger islands, are provided by **Electra**. A majority of Electra shares was sold to a consortium led by Electricidade de Portugal in 1998. A failure to adjust tariffs in response to fuel price rises led to a period of losses, but a substantial increase in tariffs at the beginning of 2003 returned the company to at least a cost recovery basis. The recently established regulatory agency will be important in establishing a clearer methodology for tariff increases, including the provision of incentives for more efficient operation, and in facilitating the elimination of budgetary subsidies. The World Bank is providing technical assistance to the new agency.

- **Financial services**. The banking system is effectively a duopoly. **Banco Comercial do Atlantico**, with about 70 percent of the market, was privatized to a Portuguese state-owned bank in 1999. The second bank, **Caixa Economica de Cabo Verde**, was also privatized to a foreign bank in 1999. The World Bank has an active program to strengthen banking supervision in Cape Verde; however, banking sector costs are high, the current market structure does not always generate competitive behavior on the part of the banks, and loan-deposit spreads are wide.

- **Transport**. Interisland maritime transport had been provided by state-owned **Arca Verde** until it went into liquidation. In its place, market provision of service is to be supplemented by the awarding of minimum service contracts for more remote areas by the government. The government plans to dispose of Arca Verde's remaining vessels shortly. Both freight and passenger air service is provided by the state-owned **TACV**. Despite a history of losses and unreliable service, recent reforms have brought the TACV near the breakeven point. The cabinet has recently approved a proposal to privatize the company, and the World Bank will be assisting the government with this process. A continuing role for the government in subsidizing service to remote locations may be appropriate following the privatization. Despite chronic arrears from the TACV, the airport services company (**ASA**) recently received a boost when the U.S. Federal Aviation Administration approved Cape Verde's safety and security systems and authorized direct flights from the United States.

- **Communications**. In 1996, **Cabo Verde Telecom** was privatized to Portugal Telecom. Communications costs remain high, however, and the new regulatory agency can play a valuable role in ensuring the cost-effective provision of services.

- **Fish freezing.** The fishery sector provides a livelihood to some 5,000 fishermen, largely in tuna. A critical role in the industry is played by the freezing and storage facilities **Salmar** and **Interbase**. The former was successfully privatized, but the latter was not (despite some investor interest), and it has had trouble paying its (rather substantial) bills to Electra. The cabinet has recently approved a new privatization process for the company that raises fewer hurdles for potential buyers.

Box 2. Structural Conditionality

Status of structural measures under the PRGF-supported program for 2002 and 2003

Structural measures under the PRGF-supported program have aimed at deepening fiscal stabilization, strengthening monetary policy, improving the efficiency of the tax and tariff structure, and reducing budgetary subsidies to public enterprises. **Structural performance criteria for 2002**, as set out at the beginning of the PRGF arrangement (April 2002), included (i) the implementation of a new central bank law; and (ii) the implementation of an automatic and transparent pricing mechanism for retail petroleum products. Both measures were implemented, though the latter one with a delay. Structural performance benchmarks for 2002 are reported on in the IMF Country Report No. 03/229.

Structural conditionality for 2003 is detailed in the MEFP (Appendix IV, Attachment I, Table 2). It includes, as a structural performance criterion, the Council of Minister's approval of the VAT preregistration decree by end-June, in order to ensure that preparations for the VAT implementation in January 2004 remain on track. This structural performance criterion and all structural performance benchmarks through October 2003 were observed.

Coverage of structural conditionality in the program for 2003–04

Structural measures through end-June 2004 focus on improving the efficiency of public services and reducing the need for budgetary subsidies to support them. **Structural performance criteria** comprise the commitment of the government (i) to refrain from providing a budgetary subsidy to Electra until a memorandum of understanding has been signed that clarifies the monitoring of fuel consumption in remote facilities; and (ii) to refrain from providing a budgetary subsidy to the TACV. These two performance criteria will be on a continuous basis. **Structural performance benchmarks** include (i) the adoption of regulations that establish the methodology for determining electricity and water tariffs at the Economic Regulatory Agency by end-June 2004; (ii) the completion of a study on streamlining tax and tariff exemptions, with support from the World Bank, by end-June 2004; and (iii) the submission of the quarterly fiscal accounts to the National Assembly by end-June 2004.

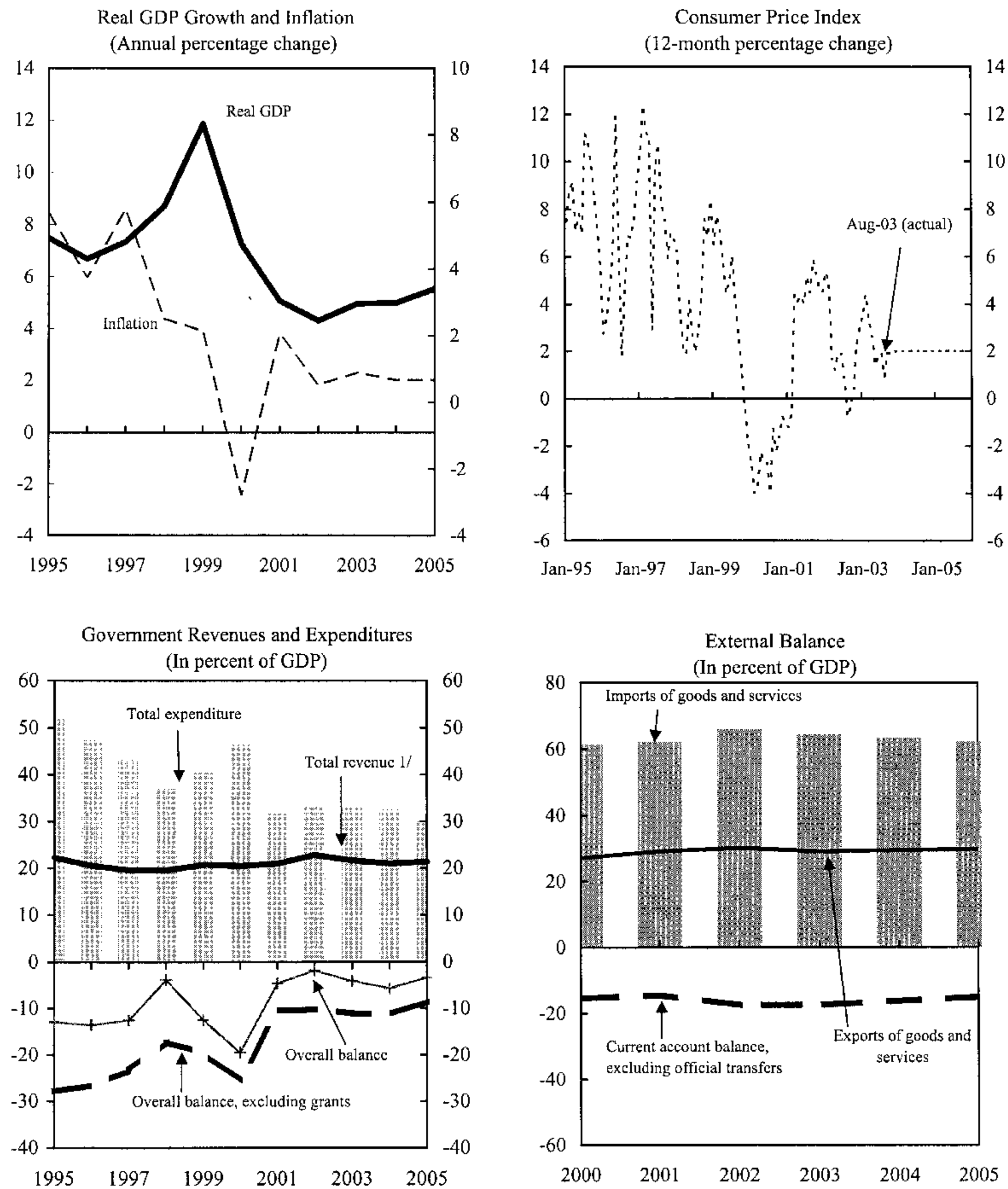
Structural areas covered by World Bank lending and conditionality

The World Bank and Fund continue to cooperate closely with regard to Cape Verde's structural reform program. There has been no overlap of conditionality with the PRGF arrangement in 2003, as the World Bank's Structural Adjustment Credit (SAC) has been fully disbursed. The World Bank is preparing to provide financial budgetary assistance in the form of a Poverty Reduction Support Credit (PRSC) in 2004 and 2005. A precondition for appraising the PRSC would be the completion of a first draft of the full PRSP.

Other relevant structural reforms not included in the current program

The discussions with the authorities covered other structural reforms, which are not subject to conditionality under the current program. These include the reduction of tax and tariff exemptions, the payment of subsidies for minimum services in key sectors (such as power, water, and transportation), civil service reform, and pension reform.

Figure 1. Cape Verde: Selected Economic Indicators, 1995–2005

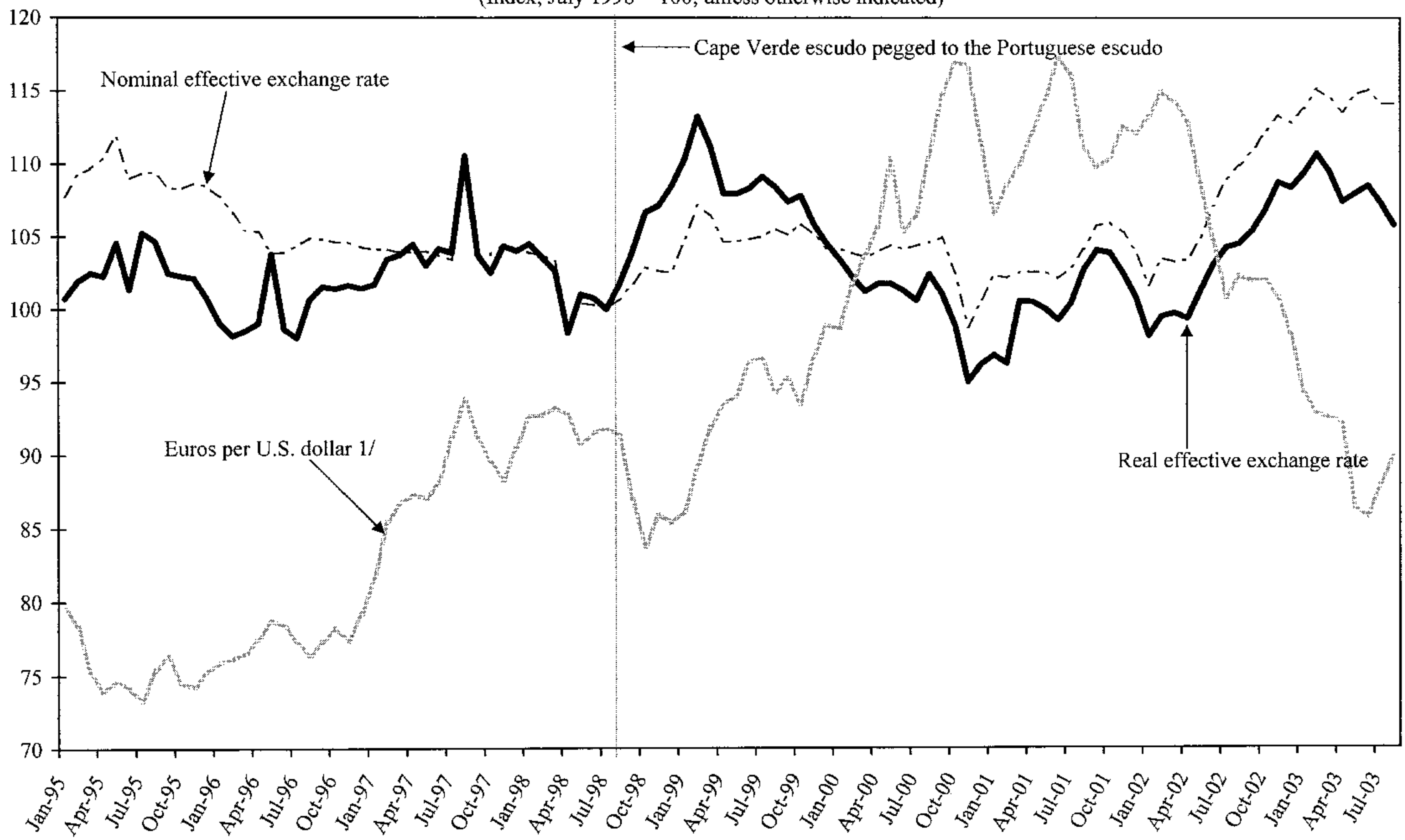


Sources: Cape Verdean authorities; and Fund staff estimates and projections.

1/ Includes domestic capital participation and net lending.

Figure 2. Cape Verde: Real and Nominal Effective Exchange Rates, January 1995–August 2003

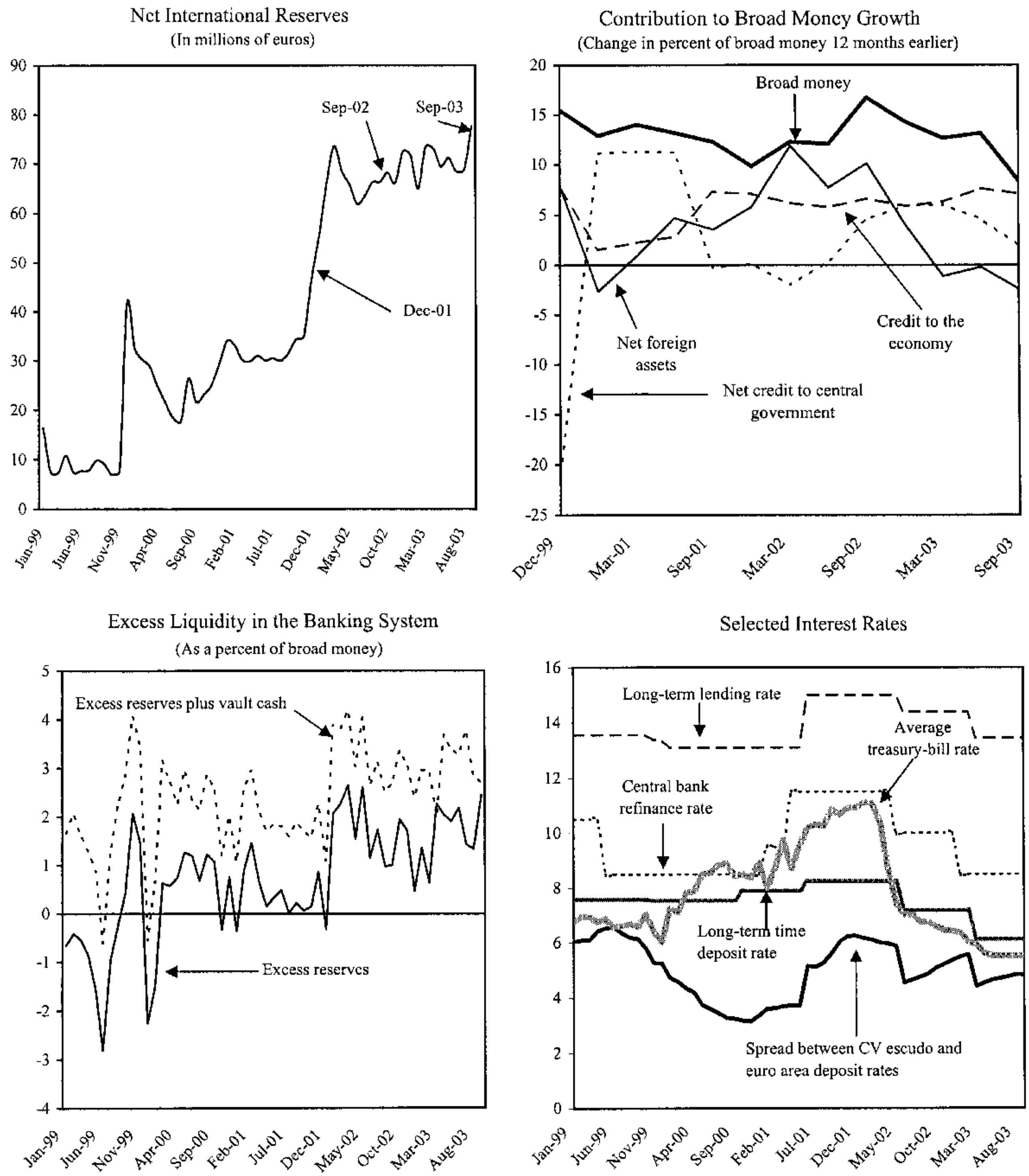
(Index, July 1998 = 100, unless otherwise indicated)



Source: International Monetary Fund, Information Notice System (INS).

1/ Prior to January 1999, based on the Portuguese escudo multiplied by the December 1998 euro-escudo conversion rate.

Figure 3. Cape Verde: Monetary Indicators, January 1999–September 2003
(In percent, unless otherwise indicated)



Sources: Bank of Cape Verde; IMF, *International Financial Statistics;* and Fund staff estimates.

Table 1. Cape Verde: Selected Economic and Financial Indicators, 2001–05

	2001	2002	2003		2004		2005
			Program 1/	Rev. Proj.	Program 1/	Rev. Proj.	Rev. Proj.
			(Annual percentage change)				
National income and prices							
Real GDP	5.1	4.3	5.0	5.0	5.0	5.0	5.5
Real GDP (per capita)	3.2	2.4	3.1	3.1	3.1	3.1	3.6
Consumer price index (annual average)	3.8	1.8	3.0	2.3	2.0	2.0	2.0
Consumer price index (end of period)	4.6	3.0	2.2	2.0	2.0	2.0	2.0
External sector							
Exports (in euros) 2/	17.5	10.5	9.7	4.1	11.5	9.0	9.8
Imports (in euros) 2/	10.6	13.8	8.2	5.2	6.5	6.1	6.1
Real effective exchange rate (annual average)	0.2	2.6	...	...	...	...	...
Terms of trade (minus = deterioration)	0.9	-0.8	-0.4	2.0	1.2	1.1	0.8
Government budget							
Total revenue (excluding grants)	12.1	16.0	11.1	2.2	6.7	4.6	10.1
Total expenditure	-25.4	12.2	5.7	6.7	3.2	6.2	0.4
Recurrent and extraordinary expenditure	-31.2	3.0	8.2	8.6	7.0	9.9	4.6
Capital expenditure	-9.6	27.8	-4.8	-0.4	2.4	4.5	-6.3
	(Annual change in percent of beginning-of-period broad money, unless otherwise indicated)						
Money and credit							
Net domestic assets	4.0	10.5	6.9	7.5	5.4	6.2	6.2
Of which: net claims on the central government	0.1	5.9	0.9	1.6	-0.8	0.0	-0.4
credit to the economy	7.1	5.9	6.0	6.1	6.2	6.2	6.2
Broad money	9.8	14.3	7.8	7.8	8.2	8.2	8.4
Income velocity (GDP/M2)	1.61	1.54	1.43	1.49	1.43	1.49	1.49
Discount rate 3/	11.5	10.0	...	...	...	...	...
			(In percent of GDP)				
Saving-investment balance							
Gross domestic investment	17.7	20.2	21.7	19.8	21.6	19.6	19.5
Public	5.2	6.2	5.7	5.7	5.4	5.6	4.8
Private	12.5	14.0	16.0	14.0	16.2	14.1	14.6
Gross national savings	7.0	8.4	11.2	9.4	10.5	9.2	9.7
Of which: public sector	5.4	10.3	8.8	6.7	8.1	5.2	6.0
External current account (including official transfers)	-10.7	-11.8	-10.6	-10.3	-11.0	-10.5	-9.8
Government budget							
Total revenue	21.0	22.8	24.5	21.7	24.2	21.0	21.4
Total grants	5.8	8.4	7.3	7.0	5.8	5.6	5.2
Total expenditure	31.5	33.0	33.8	32.7	32.2	32.2	29.9
Overall balance (including grants)	-4.6	-1.8	-2.0	-4.1	-2.2	-5.6	-3.4
Domestic bank financing	0.1	3.6	0.6	1.0	-0.6	0.0	-0.3
Total public debt 4/	91.3	84.5	80.0	81.6	76.2	80.2	77.5
External public debt 5/	62.5	54.5	51.0	53.5	50.3	53.8	53.0
Domestic public debt 6/	28.9	30.0	29.0	28.1	25.9	26.4	24.5
External current account (excluding official transfers)	-14.4	-17.3	-17.8	-17.3	-16.8	-16.1	-14.9
Overall balance of payments	2.7	3.6	0.4	0.8	-1.1	-2.0	-1.8
			(In millions of U.S. dollars, unless otherwise indicated)				
External current account (including official transfers)	-61.2	-76.1	-75.7	-79.8	-85.4	-87.3	-87.9
Gross international reserves (end of period)	41.9	79.8	83.4	90.4	99.7	104.3	117.7
Gross international reserves (in months of imports of goods and services)	1.4	2.0	2.1	2.2	2.3	2.4	2.5
External debt service (in percent of exports of goods and nonfactor services)	29.2	15.6	12.6	11.5	11.8	12.4	11.9
Memorandum items:			(In units specified)				
Nominal GDP (in billions of Cape Verde escudos)	70.5	75.4	77.9	81.2	84.2	87.5	94.7
Exchange rate (Cape Verde escudos per U.S. dollar)							
Period average	123.2	117.2	...	...	...	...	...
End period	125.1	105.1	...	...	...	...	...

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

1/ As contained in the June 11, 2003 staff report (EBS/03/78).

2/ Exports and imports of goods and nonfactor services.

3/ Central bank lending rate; in percent.

4/ Including verified stock of domestic and external arrears.

5/ Projection numbers include financing gap.

6/ Excluding the claims on the offshore Trust Fund.

Table 2. Cape Verde: Annual Fiscal Operations of the Central Government, 2001-05

	2001	2002	2003						2004		2005
			Jan.-Jun. Program	Jan.-Jun. Provisional	Jan.-Sep. Program	Jan.-Sep. Provisional	Program 1/	Rev. Proj.	Program 1/	Rev. Proj.	Rev. Proj.
					(In billions of Cape Verde escudos)						
Revenue, grants, and net lending	18.94	23.52	10.93	9.18	16.97	15.77	24.77	23.24	25.27	23.27	25.13
Domestic revenue	14.83	17.21	9.04	7.72	13.76	12.72	19.12	17.59	20.39	18.39	20.25
Tax revenue 2/	12.99	15.14	8.06	6.93	12.11	11.41	16.50	15.71	17.56	16.55	18.12
Income and profit taxes	4.79	5.59	2.85	2.47	4.30	4.05	5.80	5.54	6.40	6.08	6.73
Consumption taxes	2.10	2.47	1.16	1.02	1.79	1.69	2.62	2.50	2.85	2.69	2.89
International trade taxes 2/	5.34	6.13	3.61	3.06	5.32	5.04	7.10	6.79	7.17	6.83	7.47
Other taxes	0.76	0.95	0.45	0.39	0.69	0.63	0.98	0.87	1.14	0.94	1.04
Nontax revenue	1.54	1.85	0.54	0.68	1.09	0.88	1.75	1.33	2.03	1.58	1.88
Domestic capital participation	0.01	0.00	0.17	0.00	0.25	0.00	0.35	0.00	0.37	0.00	0.00
Net lending	0.29	0.22	0.27	0.10	0.31	0.42	0.53	0.55	0.43	0.26	0.24
External grants	4.11	6.32	1.89	1.46	3.22	3.05	5.65	5.65	4.88	4.88	4.88
Capital grants	4.11	5.16	1.34	0.91	2.67	2.50	4.88	4.88	4.88	4.88	4.88
Budget support	0.00	1.16	0.55	0.55	0.55	0.55	0.77	0.77	0.00	0.00	0.00
Total expenditure	22.19	24.89	11.70	10.74	18.14	17.78	26.30	26.56	27.16	28.22	28.32
Recurrent expenditure	14.86	15.31	7.83	7.75	11.90	11.84	16.55	16.62	17.71	18.26	19.10
Primary recurrent expenditure	13.36	13.31	6.80	6.83	10.34	10.52	14.42	14.53	15.45	16.09	16.81
Wages and salaries	6.58	7.09	3.70	3.78	5.64	6.06	7.66	8.48	8.25	9.28	9.70
Goods and services	0.57	0.60	0.26	0.29	0.40	1.09	0.60	1.54	0.64	1.66	1.72
Transfers and subsidies	5.72	4.89	2.48	2.52	3.78	2.95	5.42	3.90	5.78	4.35	4.54
Other expenditures	0.50	0.73	0.35	0.24	0.51	0.42	0.74	0.60	0.78	0.81	0.84
Domestic interest payments	0.94	1.44	0.73	0.65	1.11	0.91	1.51	1.51	1.66	1.59	1.73
External interest payments	0.57	0.56	0.30	0.27	0.45	0.41	0.62	0.58	0.59	0.57	0.56
Extraordinary expenditures	0.00	0.22	0.75	0.47	0.80	0.63	0.85	0.63	0.33	0.23	0.10
Social emergency measures	0.00	0.00	0.00	0.00	0.05	0.00	0.10	0.00	0.10	0.00	0.10
Restructuring costs	0.00	0.22	0.75	0.47	0.75	0.63	0.75	0.63	0.23	0.23	0.00
Capital expenditure	7.32	9.36	3.13	2.53	5.45	5.31	8.91	9.32	9.12	9.73	9.13
Foreign financed	6.19	8.64	2.54	2.23	4.39	4.91	7.32	8.50	7.32	8.71	7.93
Domestically financed	1.13	0.72	0.59	0.30	1.06	0.40	1.59	0.82	1.80	1.02	1.19
Overall balance, including grants 3/	-3.24	-1.37	-0.77	-1.57	-1.17	-2.01	-1.54	-3.32	-1.88	-4.94	-3.19
Financing	2.99	1.37	0.77	1.50	1.17	1.67	1.54	3.32	-0.47	2.07	0.29
Foreign (net)	2.11	1.15	1.29	1.23	1.67	2.05	1.59	3.15	0.30	1.76	0.23
Total drawings	7.56	4.14	2.19	1.98	3.06	3.18	4.10	5.28	2.99	4.38	3.05
Balance of payments, budget	5.09	1.34	0.99	0.77	1.33	0.77	1.66	1.66	0.55	0.55	0.00
Project loans	2.46	2.81	1.20	1.21	1.73	2.42	2.44	3.62	2.44	3.83	3.05
Amortization	-5.44	-2.99	-0.90	-0.75	-1.39	-1.13	-2.52	-2.13	-2.69	-2.62	-2.82
Domestic (net)	0.88	0.22	-0.51	0.28	-0.50	-0.38	-0.05	0.17	-0.78	0.31	0.05
Banking system	0.05	2.69	-0.04	0.26	0.25	0.07	0.48	0.82	-0.48	0.01	-0.25
Nonbanks	1.34	1.46	0.00	0.15	0.00	0.15	0.39	0.39	0.00	0.30	0.30
Domestic arrears 2/	-0.51	-3.94	-0.47	-0.13	-0.75	-0.60	-0.91	-1.03	-0.30	0.00	0.00
Net errors and omissions	0.25	0.00	0.00	0.06	0.00	0.34	0.00	0.00	0.00	0.00	0.00
Financing gap	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	2.36	2.87	2.91
Identified possible financing	...	...	...	...	...	...	...	...	1.69	2.24	1.03
Netherlands	...	...	...	...	...	...	...	...	0.33	0.33	0.00
European Union	...	...	...	...	...	...	...	...	0.55	0.66	0.00
African Development Bank	...	...	...	...	...	...	...	...	0.00	0.33	0.33
World Bank	...	...	...	...	...	...	...	...	0.82	0.92	0.71
Residual financing gap	...	...	...	...	...	...	...	...	0.67	0.63	1.88
Memorandum items:											
Domestic expenditures 4/	15.42	15.70	8.69	8.24	13.05	12.46	18.02	17.48	18.87	18.93	19.83
Domestic balance 5/	-0.59	1.51	0.18	-0.52	0.45	0.26	0.76	0.11	1.15	-0.54	0.42
Primary domestic balance 6/	0.34	2.95	0.91	0.12	1.56	1.18	2.26	1.61	2.82	1.05	2.15
Primary recurrent domestic balance 7/	1.46	3.89	2.08	0.89	3.17	2.20	4.35	3.06	4.57	2.30	3.44
Overall balance, excluding grants 8/	-7.35	-7.69	-2.66	-3.03	-4.39	-5.06	-7.19	-8.97	-6.77	-9.82	-8.08
Net external flows 9/	6.22	7.47	3.18	2.69	4.89	5.10	7.24	8.80	7.54	9.51	8.02

Table 2. Cape Verde: Annual Fiscal Operations of the Central Government, 2001-05 (concluded)

	2001	2002	2003						2004		2005
			Jan.-Jun. Program	Jan.-Jun. Provisional	Jan.-Sep. Program	Jan.-Sep. Provisional	Program 1/	Rev. Proj.	Program 1/	Rev. Proj.	Rev. Proj.
	(In percent of GDP)										
Revenue, grants, and net lending	26.9	31.2	14.0	11.3	21.8	19.4	31.8	28.6	30.0	26.6	26.5
Domestic revenue	21.0	22.8	11.6	9.5	17.7	15.7	24.5	21.7	24.2	21.0	21.4
Tax revenue 2/	18.4	20.1	10.4	8.5	15.5	14.1	21.2	19.3	20.8	18.9	19.1
Income and profit taxes	6.8	7.4	3.7	3.0	5.5	5.0	7.4	6.8	7.6	7.0	7.1
Consumption taxes	3.0	3.3	1.5	1.3	2.3	2.1	3.4	3.1	3.4	3.1	3.0
International trade taxes 2/	7.6	8.1	4.6	3.8	6.8	6.2	9.1	8.4	8.5	7.8	7.9
Other taxes	1.1	1.3	0.6	0.5	0.9	0.8	1.3	1.1	1.4	1.1	1.1
Nontax revenue	2.2	2.5	0.7	0.8	1.4	1.1	2.2	1.6	2.4	1.8	2.0
Domestic capital participation	0.0	0.0	0.2	0.0	0.3	0.0	0.4	0.0	0.4	0.0	0.0
Net lending	0.4	0.3	0.3	0.1	0.4	0.5	0.7	0.7	0.5	0.3	0.3
External grants	5.8	8.4	2.4	1.8	4.1	3.8	7.3	7.0	5.8	5.6	5.2
Capital grants	5.8	6.8	1.7	1.1	3.4	3.1	6.3	6.0	5.8	5.6	5.2
Budget support	0.0	1.5	0.7	0.7	0.7	0.7	1.0	0.9	0.0	0.0	0.0
Total expenditure	31.5	33.0	15.0	13.2	23.3	21.9	33.8	32.7	32.2	32.2	29.9
Recurrent expenditure	21.1	20.3	10.1	9.5	15.3	14.6	21.3	20.5	21.0	20.9	20.2
Primary recurrent expenditure	18.9	17.7	8.7	8.4	13.3	13.0	18.5	17.9	18.3	18.4	17.7
Wages and salaries	9.3	9.4	4.8	4.7	7.2	7.5	9.8	10.4	9.8	10.6	10.2
Goods and services	0.8	0.8	0.3	0.4	0.5	1.3	0.8	1.9	0.8	1.9	1.8
Transfers and subsidies	8.1	6.5	3.2	3.1	4.9	3.6	7.0	4.8	6.9	5.0	4.8
Other expenditures	0.7	1.0	0.4	0.3	0.7	0.5	0.9	0.7	0.9	0.9	0.9
Domestic interest payments	1.3	1.9	0.9	0.8	1.4	1.1	1.9	1.9	2.0	1.8	1.8
External interest payments	0.8	0.7	0.4	0.3	0.6	0.5	0.8	0.7	0.7	0.7	0.6
Extraordinary expenditures	0.0	0.3	1.0	0.6	1.0	0.8	1.1	0.8	0.4	0.3	0.1
Social emergency measures	0.0	0.0	0.0	0.0	0.1	0.0	0.1	0.0	0.1	0.0	0.1
Restructuring costs	0.0	0.3	1.0	0.6	1.0	0.8	1.0	0.8	0.3	0.3	0.0
Capital expenditure	10.4	12.4	4.0	3.1	7.0	6.5	11.4	11.5	10.8	11.1	9.6
Foreign financed	8.8	11.5	3.3	2.7	5.6	6.1	9.4	10.5	8.7	10.0	8.4
Domestically financed	1.6	1.0	0.8	0.4	1.4	0.5	2.0	1.0	2.1	1.2	1.3
Overall balance, including grants 3/	-4.6	-1.8	-1.0	-1.9	-1.5	-2.5	-2.0	-4.1	-2.2	-5.6	-3.4
Financing	4.2	1.8	1.0	1.9	1.5	2.1	2.0	4.1	-0.6	2.4	0.3
Foreign (net)	3.0	1.5	1.7	1.5	2.1	2.5	2.0	3.9	0.4	2.0	0.2
Total drawings	10.7	5.5	2.8	2.4	3.9	3.9	5.3	6.5	3.6	5.0	3.2
Balance of payments, budget	7.2	1.8	1.3	0.9	1.7	0.9	2.1	2.0	0.7	0.6	0.0
Project loans	3.5	3.7	1.5	1.5	2.2	3.0	3.1	4.5	2.9	4.4	3.2
Amortization	-7.7	-4.0	-1.2	-0.9	-1.8	-1.4	-3.2	-2.6	-3.2	-3.0	-3.0
Domestic (net)	1.3	0.3	-0.7	0.3	-0.6	-0.5	-0.1	0.2	-0.9	0.4	0.1
Banking system	0.1	3.6	0.0	0.3	0.3	0.1	0.6	1.0	-0.6	0.0	-0.3
Nonbanks	1.9	1.9	0.0	0.2	0.0	0.2	0.5	0.5	0.0	0.3	0.3
Domestic arrears 2/	-0.7	-5.2	-0.6	-0.2	-1.0	-0.7	-1.2	-1.3	-0.4	0.0	0.0
Net errors and omissions	0.4	0.0	0.0	0.1	0.0	0.4	0.0	0.0	0.0	0.0	0.0
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	2.8	3.3	3.1
Identified possible financing	...	...	...	...	...	...	...	...	2.0	2.6	1.1
Netherlands	...	...	...	...	...	...	...	...	0.4	0.4	0.0
European Union	...	...	...	...	...	...	...	...	0.7	0.8	0.0
African Development Bank	...	...	...	...	...	...	...	...	0.0	0.4	0.3
World Bank	...	...	...	...	...	...	...	...	1.0	1.1	0.7
Residual financing gap	...	...	...	...	...	...	...	...	0.8	0.7	2.0
Memorandum items:											
Domestic expenditures 4/	21.9	20.8	11.2	10.2	16.8	15.3	23.1	21.5	22.4	21.6	20.9
Domestic balance 5/	-0.8	2.0	0.2	-0.6	0.6	0.3	1.0	0.1	1.4	-0.6	0.4
Primary domestic balance 6/	0.5	3.9	1.2	0.2	2.0	1.4	2.9	2.0	3.3	1.2	2.3
Primary recurrent domestic balance 7/	2.1	5.2	2.7	1.1	4.1	2.7	5.6	3.8	5.4	2.6	3.6
Overall balance, excluding grants 8/	-10.4	-10.2	-3.4	-3.7	-5.6	-6.2	-9.2	-11.1	-8.0	-11.2	-8.5
Net external flows 9/	8.8	9.9	4.1	3.3	6.3	6.3	9.3	10.8	9.0	10.9	8.5

Sources: Ministry of Finance and Planning; Bank of Cape Verde; and staff estimates and projections.

1/ As contained in the June 11, 2003 staff report (EBS/03/78).

2/ 2003 includes exceptional revenues of CVEsc 455 million from old tax debt that were used to clear arrears of the same amount with a domestic oil company.

3/ "Overall balance, including grants" = revenue including grants – total expenditure.

4/ "Domestic expenditure" = total expenditure – external interest – foreign-financed capital expenditure – capital expenditure financed by domestic capital participation.

5/ "Domestic balance" = domestic revenue – domestic capital participation – domestic expenditure.

6/ "Primary domestic balance"= domestic revenue – domestic capital participation – domestic expenditure + domestic interest payments.

7/ "Primary recurrent domestic balance"= domestic revenue – domestic capital participation – primary current expenditure.

8/ "Overall balance, excluding grants" = revenue excluding grants – total expenditure.

9/ Excluding external interest payments, and including financing gap.

Table 3. Cape Verde: Monetary Survey, 2001-04

	2001	2002	2003							2004		
	Dec.	Dec.	March	June		Sep.		Dec.		March	June	Dec.
				Program	Actual	Program	Actual	Program	Rev. Proj.	Proj.	Proj.	Proj.
	(In millions of Cape Verde escudos)											
Net foreign assets	9,557	11,331	11,563	11,425	10,700	11,881	10,508	11,820	11,489	11,662	12,325	12,599
Foreign assets	11,489	13,841	14,088	13,987	13,293	14,599	13,492	14,694	14,708	14,929	15,643	16,497
Of which: foreign reserves	5,238	8,391	8,440	8,440	8,177	9,090	9,061	9,079	9,507	9,727	10,441	10,967
Foreign liabilities	-1,932	-2,511	-2,525	-2,562	-2,593	-2,718	-2,984	-2,874	-3,219	-3,267	-3,318	-3,898
Net domestic assets	36,239	41,027	42,288	42,473	44,072	43,578	44,371	44,641	44,972	46,493	46,987	48,493
Net domestic credit	44,093	49,916	50,263	50,752	51,904	52,168	52,713	53,528	53,844	55,296	55,725	57,361
Net claims on general government	21,665	24,790	24,425	24,614	24,897	24,967	24,767	25,268	25,533	26,197	25,929	25,544
Of which: net claims on the central government	11,676	14,368	14,217	14,323	14,629	14,608	14,435	14,841	15,185	15,849	15,581	15,197
Credit to the economy	22,428	25,126	25,838	26,138	27,007	27,201	27,946	28,261	28,311	29,099	29,796	31,816
Other items (net)	-7,854	-8,889	-7,975	-8,278	-7,832	-8,590	-8,342	-8,887	-8,871	-8,803	-8,737	-8,868
Broad money (M2)	45,796	52,358	53,851	53,898	54,772	55,459	54,879	56,461	56,461	58,155	59,312	61,092
Narrow money (M1)	20,759	22,621	22,602	22,574	22,391	23,178	21,583	23,547	22,998	23,322	23,589	23,968
Currency outside banks	6,703	6,459	5,897	5,882	5,783	6,031	5,672	6,118	5,695	5,868	5,985	6,162
Demand deposits	14,056	16,162	16,706	16,692	16,607	17,147	15,910	17,429	17,304	17,454	17,604	17,807
Quasi money	22,931	27,636	28,709	28,908	29,695	29,925	31,156	30,648	30,803	32,118	32,954	34,246
Foreign currency deposits	2,106	2,101	2,540	2,416	2,687	2,356	2,140	2,266	2,660	2,715	2,770	2,878
	(Change in percent of broad money 12 months earlier)											
Net foreign assets	5.8	3.9	-1.1	1.3	-0.2	0.3	-2.4	0.9	0.3	0.2	3.0	2.0
Net domestic assets	4.0	10.5	13.7	10.0	13.3	9.2	10.7	6.9	7.5	7.8	5.3	6.2
Net domestic credit	7.0	12.7	12.7	10.0	12.3	8.4	9.4	6.9	7.5	9.3	7.0	6.2
Of which: net claims on the central government	0.1	5.9	6.1	4.0	4.6	2.3	2.0	0.9	1.6	3.0	1.7	0.0
credit to the economy	7.1	5.9	6.3	5.8	7.6	5.6	7.1	6.0	6.1	6.1	5.1	6.2
Other items (net)	-2.9	-2.3	1.0	0.1	1.0	0.8	1.3	0.0	0.0	-1.5	-1.7	0.0
Broad money	9.8	14.3	12.6	11.3	13.1	9.5	8.4	7.8	7.8	8.0	8.3	8.2
	(In millions of Cape Verde escudos, unless otherwise specified)											
Selected monetary indicators												
Emigrant deposits	15,585	19,042	20,111	20,426	20,558	21,323	20,426	22,019	21,424	...	...	23,792
Excess reserves /total deposits (in percent)	-0.4	0.5	2.6	3.2	2.4	2.3	2.7	1.4	0.4	0.4	0.4	0.4
Money multiplier (M2 / M0)	3.14	3.22	3.19	3.24	3.21	3.30	3.22	3.37	3.38	3.38	3.38	3.38
Credit to the economy (percentage change)	15.1	12.0	13.1	12.0	15.7	11.7	14.8	12.5	12.7	12.6	14.0	12.4

Table 3. Cape Verde: Monetary Survey, 2001-04 (concluded)

	2001	2002	2003							2004		
	Dec.	Dec.	March	June		Sep.		Dec.		March	June	Dec.
				Program	Actual	Program	Actual	Program	Rev. Proj.	Proj.	Proj.	Proj.
	(In millions of Cape Verde escudos)											
Bank of Cape Verde												
Net foreign assets	5,945	8,632	8,675	8,635	8,402	9,126	9,110	8,956	9,311	9,531	10,245	10,413
Of which: net international reserves	5,100	7,984	8,093	8,033	7,844	8,501	8,552	8,308	8,736	8,956	9,508	9,838
Foreign assets	6,115	9,135	9,116	9,139	8,825	9,812	9,709	9,823	10,178	10,398	11,112	11,638
Foreign liabilities	-170	-503	-441	-503	-423	-685	-599	-867	-867	-867	-867	-1,225
Net domestic assets	8,635	7,605	8,203	7,994	8,639	7,675	7,933	7,814	7,386	7,668	7,294	7,660
Net domestic credit	9,976	9,728	9,666	9,678	9,980	9,578	9,390	9,937	9,604	9,817	9,377	9,617
Trust Fund claims	4,167	4,167	4,167	4,167	4,167	4,167	4,167	4,167	4,167	4,167	4,167	4,167
Net claims on central government	4,183	4,103	4,246	3,727	4,559	3,627	3,973	4,312	4,182	4,396	3,956	4,196
Credit to central government	4,857	5,302	5,754	5,131	5,387	4,929	4,927	5,511	4,927	5,141	4,701	4,941
Deposits of central government	-675	-1,199	-1,508	-1,405	-828	-1,302	-954	-1,199	-745	-745	-745	-745
Credit to the economy	1,189	1,184	1,186	1,184	1,187	1,184	1,190	1,184	1,188	1,188	1,188	1,188
Credit to commercial banks	438	275	67	600	67	600	60	275	67	67	67	67
Other items (net)	-1,341	-2,123	-1,464	-1,684	-1,341	-1,904	-1,458	-2,123	-2,218	-2,150	-2,084	-1,958
Reserve money (M0)	14,581	16,237	16,877	16,629	17,041	16,801	17,042	16,770	16,697	17,199	17,539	18,072
Currency outside banks	6,703	6,459	5,897	5,882	5,783	6,031	5,672	6,118	5,695	5,868	5,985	6,162
Cash in vaults	650	1,013	753	901	870	1,035	796	1,164	773	789	805	837
Deposits of commercial banks	7,227	8,764	10,213	9,832	10,386	9,720	10,570	9,486	10,225	10,538	10,745	11,070
Deposits of other financial institutions	1	1	15	15	1	15	4	1	4	4	4	4
	(Twelve-month percentage change)											
Reserve money	7.6	11.4	6.1	9.7	12.4	8.3	9.9	3.3	2.8	1.9	2.9	8.2

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

Table 4. Cape Verde: Balance of Payments, 2001–05

(In millions of Cape Verde escudos, unless otherwise indicated)

	2001	2002	2003 Program 1/	2003 Rev. Proj.	2004 Rev. Proj.	2005 Rev. Proj.
Current account balance	-7,545	-8,918	-8,234	-8,392	-9,183	-9,242
Trade balance	-24,487	-28,277	-29,740	-29,872	-31,380	-33,042
Exports, f.o.b.	4,577	4,909	5,423	4,883	5,462	6,046
Imports, f.o.b.	-29,064	-33,187	-35,163	-34,755	-36,842	-39,088
Services (net)	1,312	1,242	1,504	1,186	1,629	2,402
Credit	15,981	17,808	19,485	18,761	20,317	22,248
Of which: tourism	6,539	7,509	8,306	7,767	8,505	9,577
Debit	-14,668	-16,565	-17,982	-17,575	-18,689	-19,846
Factor income (net)	-753	-1,364	-1,267	-1,569	-1,484	-1,684
Credit	830	787	714	697	775	980
Debit	-1,583	-2,151	-1,981	-2,266	-2,259	-2,664
Government interest	-568	-557	-620	-578	-572	-560
Interest by other sectors	-859	-896	...	-934	-1,104	-1,472
Income on direct investment and other income	-156	-699	...	-754	-583	-632
Current transfers (net)	16,382	19,482	21,269	21,864	22,052	23,082
Official	2,601	4,159	5,651	5,651	4,882	4,882
Private	13,781	15,323	15,618	16,212	17,169	18,200
Capital and financial account (net)	9,545	11,329	8,559	9,071	7,413	7,559
Capital transfers	3,004	1,058	900	975	1,121	1,290
Government	0	244	0	0	0	0
Private	3,004	814	900	975	1,121	1,290
Direct investment (net)	983	1,718	2,400	1,890	2,174	2,717
Portfolio investment	180	0	0	0	0	0
Government	2,113	1,150	1,585	3,148	1,758	231
Trust Fund	0	0	0	0	0	0
Net official flows	2,113	1,150	1,585	3,148	1,758	231
Disbursements	7,557	4,144	4,102	5,278	4,381	3,053
Amortization	-5,444	-2,995	-2,517	-2,131	-2,623	-2,821
Of which: clearance of previously rescheduled arrears	-1,855	-813	-381	-381	0	0
Other capital	3,265	7,404	3,673	3,058	2,360	3,321
Commercial banks	-115	1,082	-165	521	-8	-145
Emigrant deposit flows	3,108	3,457	2,978	2,382	2,368	2,663
Commercial credit (net)	663	2,577	960	155	0	804
Other	-391	288	-100	0	0	0
Net errors and omissions	-107	276	0	0	0	0
Overall balance	1,892	2,687	324	678	-1,770	-1,683
Financing	-1,892	-2,687	-324	-678	-1,102	-1,226
Change in net foreign assets of central bank (-=increase)	-1,892	-2,687	-324	-678	-1,102	-1,226
Of which: change in net international reserves	-1,879	-2,884	-324	-752	-1,102	-1,226
Of which: IMF (net)	0	354	364	417	358	183
Exceptional financing	0	0	0	0	0	0
Change in government arrears (+=increase)	-1,855	0	-802	-802	0	0
Rescheduling/cancellation of arrears	1,855	0	802	802	0	0
Financing gap	0	0	0	0	2,872	2,909
Memorandum items:						
Current account (including official transfers) 2/	-10.7	-11.8	-10.6	-10.3	-10.5	-9.8
Current account (excluding official transfers) 2/	-14.4	-17.3	-17.8	-17.3	-16.1	-14.9
Overall balance 2/	2.7	3.6	0.4	0.8	-2.0	-1.8
Gross international reserves	5,238	8,391	9,079	9,507	10,967	12,376
In months of imports of goods and nonfactor services	1.4	2.0	2.1	2.2	2.4	2.5
External public debt	44,052	41,064	39,685	43,419	45,177	45,408
Including financing gap	...	...	...	43,419	47,061	50,201

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

1/ As contained in the June 11, 2003 staff report (EBS/03/78).

2/ In percent of GDP.

Table 5. Cape Verde: External Public Debt Outstanding, 2000–03
(In millions of U.S. dollars, unless otherwise indicated; end of period)

	2000	2001	2002	2003
Multilateral	226.9	252.2	288.4	320.1
AfDF 1/	77.9	86.2	85.5	95.5
IDA	101.9	110.1	143.4	158.1
IMF	0.0	0.0	3.3	6.9
BADEA 1/	12.5	20.6	20.6	22.5
AfDB 1/	1.3	1.3	0.6	0.2
EIB 1/	9.0	8.1	7.0	7.7
OPEC 1/	7.3	7.7	10.7	11.2
IFAD 1/	10.2	8.9	9.1	9.9
Saudi Fund 1/	0.0	0.3	0.0	0.0
NDF 1/	2.3	2.9	2.7	2.9
NTF 1/	4.5	6.2	5.4	5.2
Bilateral	74.4	77.2	82.2	86.2
Government	55.5	56.0	67.7	65.5
China	13.4	0.0	0.0	0.0
Kuwait	2.5	4.4	2.9	3.7
Portugal	24.2	41.3	44.1	44.3
South Africa	3.8	0.0	0.0	0.0
Abu Dhabi	0.2	0.2	0.1	0.0
Germany	11.4	10.1	20.6	17.5
Export credit agencies	18.9	21.2	14.5	20.7
Caisse Général des Dépôts	3.9	4.7	7.0	7.6
ICO (Spain)	6.7	7.9	1.2	6.6
CACEX (Brazil)	2.2	2.4	2.4	2.6
SOMEC (Portugal)	6.2	6.3	3.9	4.0
Private companies	...	8.2	12.4	13.8
Banco Espirito Santo	...	7.5	11.8	13.8
MSF (Portugal)	...	0.7	0.7	0.0
Total (excluding arrears)	301.3	337.6	383.0	412.9
As percent of GDP	55.3	59.9	53.4	53.5
Stock of external debt arrears	27.8	14.5	7.5	0.0
Total (including arrears)	329.1	352.1	390.5	412.9
As percent of GDP	60.4	62.5	54.5	53.5
Total (including arrears and financing gap)	329.1	352.1	390.5	412.9
As percent of GDP	60.4	62.5	54.5	53.5
In millions of Cape Verde escudos	39,004	44,052	41,064	43,419

Source: Cape Verdean authorities.

1/ AfDF = African Development Fund; BADEA = Arab Bank for Economic Development for Africa; for Africa; AfDB = African Development Bank; EIB = European Investment Bank; OPEC = Organization of Petroleum Exporting Countries; IFAD = International Fund for Agricultural Development; Saudi Fund = Saudi Fund for Development; NDF = Nordic Development Fund; and NTF = Nigeria Trust Fund.

Table 6. Cape Verde: Vulnerability Indicators, 1997–2003

	1997	1998	1999	2000	2001	2002	2003 Proj.
				(In units as indicated)			
Real effective exchange rate (annual percentage change) 1/	4.0	-0.9	5.1	-7.4	0.2	2.6	...
Nominal effective exchange rate (annual percentage change) 1/	-0.5	-2.6	3.5	-1.9	0.2	4.0	...
Nominal Cape Verde escudos/U.S. dollar rate (annual percentage change) 2/	12.8	5.3	5.4	15.6	3.0	-4.9	...
Domestic credit growth (annual percentage change)	21.2	5.6	11.3	25.2	7.1	13.2	7.9
Overall fiscal balance, including grants (in percent of GDP)	-12.6	-3.9	-12.5	-19.5	-4.6	-1.8	-4.1
Public debt (in percent of GDP)	87.1	80.6	85.1	108.4	106.4	98.6	94.6
Domestic debt, including claims on the offshore Trust Fund (in percent of GDP)	39.9	35.7	31.9	48.0	43.9	44.1	41.2
Domestic debt, excluding claims on the offshore Trust Fund (in percent of GDP)	39.9	35.7	20.9	31.6	28.9	30.0	28.1
External debt (in percent of GDP)	47.3	44.9	53.2	60.4	62.5	54.5	53.5
Scheduled external debt service relative to gross international reserves (in percent)	77.8	167.7	87.8	56.2	114.8	42.3	28.5
Scheduled external debt service relative to fiscal domestic revenues (in percent)	16.1	13.0	32.1	14.2	40.5	20.6	15.4
Gross international reserves (in months of imports of goods and nonfactor services)	0.8	0.3	1.5	1.0	1.4	2.0	2.2
Broad money relative to official reserves (in percent)	1,679.3	4,081.0	789.7	1,245.3	874.3	624.0	594.0
Broad money relative to net foreign assets (in percent)	556.3	572.0	455.5	584.1	479.2	462.1	491.5
Central bank lending rate	12.1	10.0	8.5	9.5	11.5	10.0	8.5
Private transfers (in percent of GDP)	14.3	15.7	18.4	21.0	19.5	20.3	20.0
Current account, excluding official current transfers (in percent of GDP)	-17.3	-21.4	-20.6	-15.3	-14.4	-17.3	-17.3
Exports of goods and nonfactor services relative to imports of goods and nonfactor services (in percent)	46.1	38.6	37.0	44.3	47.0	45.7	52.3
Tourism receipts and foreign direct investment (in percent of GDP)	5.4	5.5	13.5	13.5	10.7	12.2	11.9
Tourism receipts (annual percentage change)	50.9	41.7	46.3	66.2	35.6	14.8	3.4

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

1/ A minus sign symbolizes a depreciation.

2/ A minus sign symbolizes an appreciation.

Table 7. Cape Verde: Proposed Schedule of Disbursement Under the PRGF Arrangement, 2002–05

Amount	Available Date	Conditions Necessary for Disbursement 1/
SDR 1.23 million	April 4, 2002	Executive Board approval of the three-year annual arrangement.
SDR 1.23 million	December 16, 2002	Observance of the performance criteria for June 30, 2002 and completion of the first review under the arrangement.
SDR 1.23 million	June 26, 2003	Observance of the performance criteria for December 31, 2002 and completion of the second review under the arrangement.
SDR 1.23 million	December 20, 2003	Observance of the performance criteria for June 30, 2003 and completion of the third review under the arrangement.
SDR 1.23 million	June 30, 2004	Observance of the performance criteria for December 31, 2003 and completion of the fourth review under the arrangement.
SDR 1.23 million	December 20, 2004	Observance of the performance criteria for June 30, 2004 and completion of the fifth review under the arrangement.
SDR 1.26 million	March 16, 2005	Observance of the performance criteria for December 31, 2004 and completion of the sixth review under the arrangement.

Source: International Monetary Fund.

1/ Other than the generally applicable conditions under the Poverty Reduction and Growth Facility (PRGF) arrangement.

Cape Verde: Relations with the Fund
(As of September 30, 2003)

I. **Membership Status**: Joined 11/20/1978; Article XIV

II. **General Resources Account**:	SDR million	%Quota
Quota	9.60	100.0
Fund holdings of currency	9.60	99.96
Reserve position in Fund	0.00	0.05

III. **SDR Department**:	SDR million	%Allocation
Net cumulative allocation	0.62	100.0
Holdings	0.00	0.61

IV. **Outstanding Purchases and Loans**:	SDR million	% Quota
Poverty Reduction and Growth Facility (PRGF) Arrangement	3.69	38.44

V. **Financial Arrangements**:

Type	Approval date	Expiration date	Amount approved (SDR million)	Amount drawn (SDR million)
PRGF	4/10/2002	4/09/2005	8.64	3.69
Stand-By Arrangement	02/20/1998	03/15/2000	2.50	0.00

VI. **Projected Obligations to Fund** (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2003	2004	2005	2006	2007
Principal	0.00	0.00	0.00	0.00	0.12
Charges/interest	0.01	0.03	0.03	0.03	0.03
Total	0.01	0.03	0.03	0.03	0.15

VII. **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 the IMF Country Report No. 03/152. The BCV has taken steps to implement many of the recommendations and has requested technical assistance for the rest.

VIII. **Exchange Arrangements**:

The currency of Cape Verde, the Cape Verde escudo, was pegged to the Portuguese escudo from mid-1998 to end-1998, and from January 4, 1999 it has been pegged to the euro, at a rate of CVEsc 110 per EUR 1. There are no taxes or subsidies on purchases or sales of foreign exchange. There are no arrangements for forward cover against exchange rate risk operating in the official or the commercial banking sector.

IX. **Article IV Consultation**:

Discussions of the 2002 Article IV consultation and the first review under the PRGF arrangement were held in Praia during October 13-27, 2002. The Executive Board concluded the discussions of the Article IV consultations and completed the first review under the PRGF on December 16, 2002 (IMF Country Report No. 03/152). The previous Article IV consultation discussions were held in Praia during the period March 3-16, 2001. The Executive Board approved its conclusion on June 15, 2001 (IMF Country Report No. 01/174). It is expected that the next Article IV consultation with Cape Verde will be held on the 24-month cycle, subject to the provisions of the decision on consultation cycles approved on July 15, 2002.

X. **Technical Assistance**:

Since 1985, the Fund has provided technical assistance to both the Bank of Cape Verde and to the Ministry of Finance in several areas: (i) the Bank of Cape Verde has received technical 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; (ii) the Ministry of Finance has received technical assistance from FAD, in organization and budgetary procedures, budgeting, tax policy, and tax administration; and (iii) STA missions have aimed at improving the money and banking, balance of payments, national accounts, and general statistics (Cape Verde is a participant in the GDDS Regional Project for Lusophone Africa). Most recently, the following steps have been taken:

- In July 2003, an MFD expert visited the Bank of Cape Verde to advise on safeguards issues.
- The most recent technical assistance mission on balance of payments statistics was conducted during August 26-September 6, 2002.
- An FAD mission, in June-July 1999, and an advisor (resident from March 2000 – December 2002 and peripatetic since then) have been advising the authorities on the rationalization of the import tariff and the overhaul of the domestic indirect tax system, including the January 2004 introduction of a value-added tax (VAT).

XI. **Resident Representative:** None

Cape Verde: IMF-World Bank Relations

Partnership in Cape Verde's development strategy

1. The government of Cape Verde's development strategy is set forth in the interim poverty reduction strategy paper (I-PRSP) (www.imf.org). The I-PRSP focuses on promoting governance, entrepreneurial capacity, competitiveness, and growth; developing human capital through the education and training system; promoting social development, combating poverty, and strengthening cohesion and solidarity; and developing basic and economic infrastructure. The authorities are now preparing their final PRSP (expected in early 2004).

2. The IMF is supporting Cape Verde's poverty reduction efforts through a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF). The Fund-supported program continues the implementation of sound macroeconomic policies, while increasing the share of poverty reduction-related public spending. The Fund takes the lead in the policy dialogue on macroeconomic policies including overall fiscal and monetary policy. In addition to macroeconomic targets, the PRGF-supported program establishes structural performance criteria relating to areas such as value-added tax (VAT) implementation, strengthening the independence of the central bank, and improving the financial performance of state-owned and public service enterprises.

World Bank Group strategy

3. The objective of the World Bank Group's assistance strategy is to help Cape Verde reduce poverty by supporting the government's I-PRSP and forthcoming PRSP. The Bank has engaged the government in a dialogue on budget support, on the basis of sector programs presented in the forthcoming PRSP. The Bank's current strategic focus supports efforts in the areas of (i) macroeconomic management and institutional capacity building; (ii) policy reforms in support of private sector development; and (iii) human resource development and poverty reduction. The Bank's next Country Assistance Strategy (CAS), which is expected to support policy areas to be defined in the forthcoming PRSP, will ascertain these priorities. Bank-supported interventions aim at broadening the basis of private sector participation in Cape Verde's economy and enhancing private sector competitiveness. Components of the strategy include the following: improving the investment climate; building institutional capacity; implementing pension reforms; and modernizing and restructuring the financial sector.

World Bank Group activities and assessment of country policies

IDA portfolio

4. The current World Bank portfolio gives a high priority to capacity building in the social, public, and infrastructure sectors, and to the careful introduction of market-based incentives for private sector development. These central themes have also been identified in the

country's I-PRSP as key pillars on which to base the future of the country's development strategy.

5. In strengthening the country's physical infrastructure, the Transport and Infrastructure Project has supported the large-scale contracting of road works to local construction enterprises. 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 Privatization Project is developing local capacity to design and implement reforms in the public enterprise sector, monitor performance, and build private sector capacity through training. The Growth and Competitiveness Project, which recently became effective, supports the private sector development strategy.

6. Two projects that were approved in fiscal-year 1999 in the social sectors are still active. The Social Sector Development Project supports poverty reduction for the 30 percent of the population living below the poverty line by (i) assisting the government in restructuring the labor-intensive public works program (FAIMO) by creating an institutional capacity (AGECABO) to execute public works; (ii) strengthening the capacity of municipalities, communities, and nongovernmental organizations (NGOs) in carrying out cost-effective poverty alleviation interventions; and (iii) establishing a central capacity to coordinate, monitor, and evaluate the poverty alleviation programs. The Education Sector Project supports the development of a technically and financially sustainable education and training system that will ensure an educated and flexible workforce commensurate with Cape Verde's social and economic goals. An HIV/AIDS project went into effect in 2002. The credit 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.

Assessment of country policies

7. The authorities of Cape Verde and development partners, including the Bank, have undertaken a substantial body of analytic work over the past two years to assess key social, structural, and sectoral development policies and identify policy and institutional reform priorities for poverty reduction. Regarding strategic policymaking, the Bank has provided advice on the I-PRSP and sector strategies.

8. In the area of public sector management, the authorities have sought partners' advice on strengthening the administration's capabilities. In that connection, the Bank is producing a study on the role of the state and a public expenditure review, leading a study of the pension system, participating in a Country Financial Accountability Assessment (along with the Netherlands and the European Union) and an assessment of the procurement mechanisms of the state, and supporting important statistical work (such as a household survey).

9. In addition to advisory services, the Bank has shifted toward providing direct support of the administration with structural adjustment credits. A structural adjustment operation was approved in December 2001, and a supplemental was approved in December 2002. They both closed in June 2003. The associated credits supported the government's stabilization program and helped implement critical structural reforms in support of renewed growth and poverty alleviation by (i) implementing structural reforms in the petroleum sector; (ii) supporting an accelerated privatization program in the transport and infrastructure sector; (iii) creating an environment conducive to private sector development and enhancing revenue mobilization; and (iv) strengthening fiscal and balance of payments sustainability.

10. As of September 30, 2003, IDA had extended 20 credits to Cape Verde, amounting to about US$194 million equivalent, of which about US$156 million equivalent has been disbursed. Thirteen credits have closed, and the current portfolio includes seven active projects, with associated credit amounts of about US$74 million equivalent and an undisbursed balance of about US$37 million.

IFC and MIGA activities

11. The involvement of the International Finance Corporation (IFC) in Cape Verde is limited. As of August 2003, IFC had two investments in its portfolio totaling US$0.7 million: IFC's African Enterprise Fund is financing shoe manufacturing (US$0.1 million); and IFC's Small Enterprise Fund is financing public transportation ($0.6 million) for the addition of new buses to the Moura Company's fleet and the modernization of its facilities. MIGA's portfolio in Cape Verde consists of two contracts of guarantee in the mining sector with a $1.1 million exposure. The total amount of foreign direct investment facilitated to date is $2.2 million.

World Bank partnership outlook

12. The Bank's medium-term approach will selectively identify some of its programs for focused assistance and advice. Financial support is expected to take the form of a Poverty Reduction Support Credit (PRSC), which would provide budgetary support on the basis of an agreed reform program. The World Bank, IFC, and MIGA will continue to coordinate their respective roles to support development activities in Cape Verde.

World Bank-Fund collaboration in specific areas

13. The Fund and the Bank continue to collaborate in many areas, including fiscal operations and tax reform; public enterprise reform and privatization; utility regulation and private sector development; and the strengthening of human resource development and the poverty reduction strategy. In close collaboration with the World Bank, the Fund staff has discussed and reached understandings on a structural reform program with the government of Cape Verde in the context of the PRGF arrangement. The Fund and the Bank have collaborated in the areas of the privatization program, utility regulation, public expenditure management, and civil service and pension system reform.

14. Questions may be referred to Mr. John McIntire (tel.: 1-221-849-5011), Ms. Francoise Perrot (tel: 1-202-0473-4465), or Mr. Jean van Houtte (tel.: 1-202-473-0156).

Relations with the World Bank Group:

Statement of IDA Operations

(As of September 30, 2003; in millions of U.S. dollars)

Credit No.	Projects	Principal Amount	Disbursed	Undisbur-sed	Approved Date	Closing Date
	13 credits closed	*119.8*	*117.0*	*0.1*		
3755	Growth & Competitiveness	11.5	0.0	12.0	13-May-03	28-Feb-08
36290	HIV/AIDS	9.0	1.6	8.7	28-Mar-02	31-Dec-06
24661	Transport Infrastructure Suppl.	5.0	2.1	3.4	30-Jan-01	31-Dec-03
32230	Education &Training Consolidation	6.0	5.2	0.7	25-May-99	30-Jun-03
31210	Privatization Technical Assistance	9.0	7.6	1.6	21-Jul-98	31-Dec-03
32050	Energy/Water	17.5	7.6	9.6	11-May-99	30-Jun-04
32240	Social Sector Development	16.1	15.1	0.7	25-May-99	31-Aug-03
	Total active projects	74.1	39.2	36.7		
	Active and closed projects	193.9	156.2	36.8		

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

Statement of IFC Investments

(In millions of U.S. dollars)

FY Approv.	Company	Type of Business	Original Gross Commitments Loan	Equity	Quasi	Partic	Disbursed 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
2001	Moura 2/	Transport	0.63	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total portfolio			0.78	0.00	0.00	0.00	0.15	0.00	0.00	0.00

1/ Growela = shoe manufacturing.
2/ Moura = public transportation.

DEBT SUSTAINABILITY ANALYSIS

1. The previous debt sustainability analysis (DSA) for Cape Verde (Appendix II of EBS/02/54, 3/22/02) concluded that, with a stable external environment and continued prudent economic policies, Cape Verde's debt ratios would remain stable over the projection period, with steadily improving debt dynamics. The present DSA revisits that conclusion and examines whether the country's debt dynamics could support limited recourse to nonconcessional borrowing. Specifically, the analysis tests for debt sustainability should the authorities proceed to contract two loans for a total of US$10 million from the OPEC Fund for International Development. These loans, which are currently under consideration, would carry a grant element of only 29 percent, slightly below the concessionality threshold of a 35 percent grant element.

2. The analysis was prepared on the basis of loan-by-loan data provided by the authorities for debt outstanding as of September 2003. Projected disbursements and payments were included to estimate debt outstanding at end-2003. At end-2003, publicly held external debt is projected to be US$420 million.

3. Given the considerable importance of loans provided on concessional terms, the end-2003 external debt stock will amount to only US$257 million in net present value (NPV) terms, equivalent to 33 percent of GDP (Appendix III, Table 1). Of this total, 65 percent is owed to multilateral institutions, 25 percent to bilateral creditors, and 10 percent to commercial creditors (all measured in NPV terms). Cape Verde remains current on its external debt service obligations, has cleared all arrears on its external debt to multilateral creditors, and has rescheduled arrears with all but two bilateral creditors. Discussions with these creditors are still ongoing.

Table 1. Cape Verde: Net Present Value of Disbursed Debt Outstanding, 2002-08
(In millions of U.S. dollars)

	2002	2003	2004	2005	2006	2007	2008
	Actual	Projected					
NPV of debt outstanding as of end-2003	**239**	**257**	**241**	**227**	**213**	**202**	**189**
Multilaterals	151	167	166	164	163	161	157
IMF	5	5	5	6	6	6	5
IDA	75	74	76	78	79	81	82
Others	70	88	84	81	78	74	70
Official bilaterals	61	64	57	48	39	33	25
Paris Club	21	22	18	14	10	8	6
Non-Paris Club	40	42	38	34	29	24	19
Commercial	25	26	19	15	11	9	7

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

Main assumptions underlying the baseline medium-term scenario

4. The baseline scenario for the debt sustainability analysis is based on the medium-term macroeconomic framework and baseline assumptions agreed with Fund staff, with projections until 2008 (Appendix III, Table 2). The baseline scenario projects export growth of 9-10 percent, somewhat below historical averages. It also takes into account future disbursements under existing loans as well as disbursements on debt not yet contracted. It uses the balance of payments projections for loan disbursements in the Poverty Reduction and Growth Facility (PRGF)-supported program (Table 4) for 2004 and 2005 and assumes US$40 million in new disbursements for the period 2006-08 (Appendix III, Table 3). This is consistent with average disbursements since the mid-1990s.

5. Of the projected disbursements over 2004-08, only about 20 percent will be made from already contracted loans. The two new loans from the OPEC Fund are included and assumed to be fully disbursed in 2004. The balance is assumed to carry, on average, terms comparable to those provided by the Arab Bank for Economic Development in Africa (BADEA): 40 years' maturity; 10 years' grace; and a 2 percent interest rate. This is less concessional than IDA terms and reflects Cape Verde's ineligibility for some lenders' most concessional lending windows.

Table 2. Cape Verde: Macroeconomic and External Baseline Assumptions, 2003-08

	2003	2004	2005	2006	2007	2008
Real GDP growth (in percent)	5.0	5.0	5.5	6.0	6.0	6.0
Export growth (U.S. dollar terms, in percent)	16.1	9.0	9.8	10.3	10.3	8.5
Import growth rate (U.S. dollar terms, in percent)	18.8	6.1	6.1	6.8	7.0	5.8
Grant element of new external borrowing (in percent)	...	43.0	46.8	48.4	48.0	48.8

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

Debt sustainability outlook

6. The baseline medium-term debt sustainability scenario, together with alternative scenarios to test the robustness of the outlook in the face of unforeseen shocks, is presented in Appendix III, Table 4. Under the assumptions of the baseline scenario, Cape Verde's debt appears sustainable, as debt ratios decline steadily: the ratios of the NPV of external debt to exports, of the NPV of external debt to GDP, and of debt service to exports all decline to comfortable levels. The ratio of the NPV of external debt to exports is projected to fall from 140 percent in 2002 (comfortably below the Heavily Indebted Poor Countries (HIPC)

Initiative threshold of 150 percent) to 95 percent in 2008, an average drop of more than 7 percentage points per year. Similarly, the ratio of the NPV of external debt to GDP is projected to fall from 37 percent in 2002 to 27 percent in 2008.

Table 3. Cape Verde: Projected Loan Disbursements, 2004-08
(In millions of U.S. dollars)

	2004	2005	2006	2007	2008
New disbursements	61.9	34.4	40.0	40.0	40.0
Multilaterals	57.1	30.4	14.1	9.3	4.3
IMF	3.4	1.8	0.0	0.0	0.0
IDA	26.7	17.5	6.8	3.9	1.8
BADEA	4.2	4.4	2.9	1.8	0.9
OPEC	11.4	1.2	0.7	0.3	0.0
of which new loans	10.0	0.0	0.0	0.0	0.0
Others	11.4	5.5	3.7	3.3	1.6
Official bilaterals	2.1	2.1	1.0	0.7	0.0
Paris Club	0.0	0.0	0.0	0.0	0.0
Non-Paris Club	2.1	2.1	1.0	0.7	0.0
Commercial	2.8	1.9	0.0	0.0	0.0
Unidentified financing 1/	0.0	0.0	24.9	30.0	35.7
Total					
NPV of cumulative new disbursements	31.4	49.6	72.3	95.7	119.9
Multilaterals	27.0	42.2	50.0	54.9	56.8
IMF	2.7	3.9	3.9	3.6	2.9
IDA	6.3	13.3	16.5	18.7	20.2
BADEA	3.4	6.2	8.1	9.1	9.5
OPEC	8.4	8.5	8.6	8.7	8.8
Others	6.2	10.3	12.9	14.7	15.4
Official bilaterals	1.8	3.4	4.1	4.4	4.1
Paris Club	0.0	0.0	0.0	0.0	0.0
Non-Paris Club	1.8	3.4	4.1	4.4	4.1
Commercial	2.6	3.9	3.3	2.7	2.1
Unidentified financing 1/	0.0	0.0	14.9	33.7	57.0

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

1/ Includes projected financing gaps. BADEA financing terms apply.

7. To test for the robustness of these conclusions, the DSA looks at the impact of four stress tests on the debt dynamics, illustrating alternative kinds of shocks.[1] The first is a simulation of weak export growth in the years 2004-05. For those two years, exports are assumed to grow at the historical average minus two standard deviations. The second stress test assumes the non-interest current account (NICA) balance will be two standard deviations worse than the historical average in 2004-05. The third test is a combination of the export growth downturn and NICA balance at historical average minus one standard deviation. The fourth and final stress test looks at a possible downturn (by two standard deviations) in the level of official grants in 2004-05.

8. All four stress tests result in declining external indebtedness indicators, suggesting continuing sustainability in the face of moderate shocks (Appendix III, Table 4). Indeed, as a result of the baseline assumption of a slowing of export growth relative to trend, the outcomes are not strikingly worse than the baseline case, with the ratio of the NPV of debt to exports declining from 140 percent in 2002 to less than 100 percent in two of the scenarios, and to around 110 percent in two others. Results for other debt indicators are broadly similar

9. The analysis therefore confirms that, under reasonable assumptions regarding new borrowing and export growth, Cape Verde's debt burden will continue to ease over coming years, as indicated by the previous DSA, even with the addition of the proposed OPEC loans.

[1] In the DSA framework, the stress tests create incremental increases in new debt. This new debt is assumed to carry terms similar to those offered by the OPEC Fund: 3 percent interest, 20 years' maturity, and 5 years' grace.

Table 4. Cape Verde: External Debt Indicators 1/
(In percent, unless otherwise indicated)

	2002	2003	2004	2005	2006	2007	2008
	Actual			Projections			
Net present value (NPV) of debt-to-exports ratio 2/							
Baseline	140	132	123	112	106	100	95
Stress test							
1. Export growth at historical average minus two standard deviation in 2004-05	140	132	124	114	107	102	96
2. NICA at historical average minus two standard deviations in 2004-05	140	132	134	131	124	117	111
3. Export growth and NICA at historical averages minus one standard deviation in 2004-05	140	132	128	119	111	105	99
4. Net official transfers at historical average minus two standard deviations in 2004-05	140	132	135	133	126	119	113
Ratio of debt service to exports 3/							
Baseline	12.7	10.7	12.2	10.1	9.0	7.0	6.8
Stress test							
1. Export growth at historical average minus two standard deviation in 2004-05	12.7	10.7	12.3	10.3	9.2	7.1	6.9
2. NICA at historical average minus two standard deviations in 2004-05	12.7	10.7	12.2	10.4	9.5	7.5	7.3
3. Export growth and NICA at historical averages minus one standard deviation in 2004-05	12.7	10.7	12.0	9.9	9.0	7.0	6.8
4. Net official transfers at historical average minus one standard deviations in 2004-05	12.7	10.7	12.2	10.4	9.6	7.6	7.3
Other debt indicators (baseline)							
NPV of debt-to-GDP ratio	37.1	33.3	32.8	30.8	29.3	28.2	27.0
NPV of public debt-to-revenue ratio 4/	163	154	156	144	135	151	145
Public debt service-to-revenue ratio 4/	16.7	14.4	17.9	15.3	14.4	14.0	14.1

Averages and standard deviations	Historical Average 5/	Historical St. Dev. 5/	Average 2003-08
Noninterest current account balance	-9.8	1.8	-8.7
Export growth (U.S. dollar terms, in percent)	13.6	2.6	9.8
Official grants-to-GDP ratio (in percent)	5.7	2	5.2

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

1/ Public debt.

2/ Based on three-year backward-looking average of exports of goods and services. NICA = noninterest current account balance.

3/ Based on current-year exports of goods and services.

4/ Central government revenue, excluding grants.

5/ For the period 1999-2003.

December 2, 2003

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. Köhler:

On April 4, 2002, the Executive Board of the IMF approved a three-year arrangement for Cape Verde under the Poverty Reduction and Growth Facility (PRGF) in the amount of SDR 8.64 (90 percent of quota). The purpose of this letter is to inform you of the progress in implementing the second-year economic program, and to request the fourth loan disbursement upon completion of the third review under the arrangement.

The attached memorandum of economic and financial policies (MEFP) supplements the MEFPs of March 11, 2002; December 6, 2002; and June 9, 2003. It sets out the objectives and policies the government of Cape Verde will pursue during the remainder of 2003 and the first half of 2004.

Cape Verde's economic performance in 2003 has been generally as envisaged under the program, and important structural reforms have been undertaken. As discussed more fully in the MEFP, however, fiscal and monetary conditions during the first half of 2003 were more expansionary than programmed, and three performance criteria (and one indicative limit) for end-June were not observed.

The government believes that the measures it has recently taken, and the policies it intends to pursue in the period through June 2004 (as described in the attached MEFP), will correct earlier policy slippages, as well as help to establish the conditions for achieving a high level of sustainable economic growth and a reduction in poverty. On this basis, the government of Cape Verde requests the completion of the third review under the arrangement. In that connection, the government is requesting waivers for the non-observance of the end-June 2003 performance criteria pertaining to net credit to the central government from the banking system, net domestic assets of the central bank, and net international reserves, as well as a modification of the performance criterion for end-December 2003 on net bank credit to the government. It also requests a modification of the end-December 2003 performance criterion for non-concessional external borrowing to permit the financing of projects in the social sectors.

The government believes that the measures and policies set forth in the attached memorandum are adequate to achieve its program objectives, but will take any further action that may prove necessary for this purpose. For as long as Cape Verde has outstanding financial obligations to the Fund arising from the loans under the arrangement, the government will consult with the Fund, at the initiative of the government or whenever the Managing Director requests consultation, on Cape Verde's economic and financial policies.

The government authorizes the Fund to provide this letter, the attached memorandum, and the associated staff report to all interested parties that request them, including through the Fund's external website.

Sincerely yours,

/s/

José Maria Pereira Neves

Prime Minister and Minister of Finance,
Planning, and Regional Development

Attachments: Memorandum of Economic and Financial Policies
Technical Memorandum of Understanding

Cape Verde

Supplementary Memorandum of Economic and Financial Policies for October 2003-June 2004

I. Introduction

1. Cape Verde's ongoing program of economic stabilization and reform is being supported by an arrangement under the Poverty Reduction and Growth Facility (PRGF) covering the period 2002-04. Consistent with the goals set out in our memorandum of economic and financial policies dated March 11, 2002, and updated most recently on June 9, 2003, this supplementary memorandum reviews the implementation of the program so far in 2003 and sets forth the government's policies through June 2004.

II. Economic and Policy Developments through September 2003

2. Economic performance in 2003 has been broadly in line with the program. With a strong rebound in agriculture, output growth of 5 percent is expected for the year. Consumer prices increased 1.9 percent during the 12 months to end-August, and, on this basis, we expect that inflation will average about 2 percent for the year as a whole. However, the balance of payments has shown a certain softness, in part because of recession in Cape Verde's main trading partners, which has resulted in sluggish exports, tourism receipts, and foreign investment. Fiscal policy was looser than we had intended, which, together with an accommodative monetary policy, put further pressure on the balance of payments and resulted in the nonobservance of three quantitative performance criteria for June (Table 1).

3. Fiscal revenues in the first half of the year were about 2 percent of GDP lower than programmed, reflecting the effect of sluggish import growth on customs, a delay in collecting tax arrears, and financial stress in publicly owned enterprises. Total expenditures were lower by almost as much (1.8 percent of GDP). Much of the expenditure restraint reflected lower financial obligations to former public enterprise workers, lower interest obligations, and a less rapid implementation of the foreign-financed component of the public investment program than originally envisaged, which offset overruns elsewhere, including unbudgeted subsidies amounting to CVEsc 200 million to state-owned enterprises. While the overall fiscal deficit (excluding grants) was only marginally larger than programmed, the domestic fiscal deficit (revenues less domestic expenditures) was larger by about 1 percent of GDP, necessitating additional recourse to domestic bank financing.

4. To enhance tax yields, the government increased penalties for the late payment of taxes and assigned the Directorate General for Assessment and Taxes (DGCI) a share of the tax penalties it collects. Domestic expenditures will be about CVEsc 540 million less than programmed this year. In addition, the government eliminated the interest subsidy paid on emigrant deposits, which will save ¼ percent of GDP on an annual basis in 2004.

5. While we believe that the revenue measures will quickly begin to bear fruit, we are cautiously projecting revenues for 2003 to be on the order of CVEsc 17.6 billion (21½ percent of GDP), against a programmed 24½ percent. Total expenditures will be on the order of CVEsc 26.6 billion (32½ percent of GDP), and net official flows (including grants) will be nearly sufficient to cover the deficit. The need for domestic financing will be small (about 0.2 percent of GDP), and the primary recurrent balance is still projected to be nearly 4 percent of GDP. Nonetheless, the need for additional domestic financing will be about 1 percent of GDP higher than programmed, given the downward revision in projected external debt service, to which a program adjuster applies. Against this background, the government requests a modification of the end-December 2003 performance criterion on net bank credit to the government to raise the ceiling by CVEsc 0.8 billion (1 percent of GDP).

6. The excess financing requirement of the government in the first half of 2003 was filled by a drawdown of deposits at the central bank, leading to excessive growth in net credit of the banking system and a decline in net international reserves. The Bank of Cape Verde (BCV) has subsequently tightened monetary policy to help ensure that the program target for the accumulation of international reserves is achieved.

7. Progress on the structural front has been positive, with key program measures undertaken on schedule, as indicated in Table 2. Progress has been particularly favorable in the following areas:

- Work is on track for the introduction of the value-added tax (VAT) on January 1, 2004. The Council of Ministers approved the preregistration decree in June (a performance criterion under the program), and amended the National Accounting Plan in September (a benchmark). The VAT has been included in the 2004 budget recently submitted to the National Assembly, and, with the work plan for remaining technical preparations currently on schedule, a relatively smooth introduction at the start of 2004 is expected.

- Similarly, preparations for the reform of customs duties are nearly complete. Together with the VAT, tariff reform will become effective on January 1, 2004. The new tariff structure will be streamlined into seven tariff bands ranging from zero to 50 percent, and the customs fee will be eliminated.

- Reforms of national airline TACV are beginning to bear fruit. As a result of actions to cut unprofitable routes and operate more efficiently, financial losses have been significantly reduced, and it is hoped that the airline will break even for 2003 as a whole. The Council of Ministers has recently decided to prepare the company for privatization.

- Following the failure of the first tender for lack of investor interest, the Council of Ministers has adopted a new strategy for the privatization of the fish-freezing company Interbase that lowers the cost of bids preparation by prospective buyers.

- Subsidy payments to Electra (the electricity and water utility) have been lower than programmed. A recently completed audit of the company concluded that the 25 percent increase in electricity tariffs and 20 percent increase in water tariffs implemented in January 2003 will be sufficient to produce the first operating surplus for the company since it was privatized. Electra's financial position was also aided by the government's payment of all its accumulated arrears to the utility early in the year.

- The independent Economic Regulatory Agency (ARE) was established in August 2003, thereby meeting one of the structural performance benchmarks under the program. The ARE will have responsibility for price regulation in energy, water, telecommunications, and urban and maritime passenger transport.

III. Medium-Term Macroeconomic Objectives and Strategy

8. With the government's attention focused on updating the National Development Plan, which was completed in April 2003, the preparation of the PRSP has been subject to some delay. The process is now on track, however, with the establishment in July 2003 of a steering committee for the participatory process. The National Institute of Statistics has recently completed the analysis of the household expenditure survey, a key element of the poverty diagnostics. With these building blocks in place, a drafting committee was appointed in October, and the government intends to produce a draft poverty reduction strategy paper (PRSP) by the end of 2003, finalizing it by March 2004.

9. The government believes that the strategy and policies supported by the PRGF arrangement remain appropriate going into 2004. The foundations of that strategy remain as follows:

- maintaining price stability by sustaining the exchange rate peg through a monetary policy aimed at reserve accumulation;

- maintaining fiscal discipline in order to free resources for the private sector, reduce pressure on the external current account, and support a reduction in interest rates;

- implementing reforms to enhance private sector competitiveness and promote economic growth; and

- accelerating public investment in health, education, and infrastructure to reduce poverty, particularly once the PRSP is completed.

10. In support of the PRSP, the government has begun to develop a medium-term expenditure framework for 2004-06 with donor assistance. The key macroeconomic assumptions underpinning this framework are broadly consistent with those of the PRGF arrangement set forth in our previous memorandum: (i) real GDP growth on the order of 5-7 percent; (i) inflation between 2 percent and 3 percent; and (iii) a gradual increase in gross

international reserves to the equivalent of 2½–3 months of imports of goods and services. Broad money is projected to grow broadly in line with nominal GDP, and credit to the economy would need to grow somewhat more rapidly to provide the necessary support to the private sector. Continued fiscal consolidation and donor budget support will be needed if we are to achieve these objectives.

IV. The Program for 2004

11. The government's draft 2004 budget projects real economic growth in the range of 5 percent and an inflation rate of 2–2.5 percent. The external position is expected to improve moderately, with the external current account deficit (excluding official transfers) in the range of 15-16 percent of GDP and an increase in international reserves from 2.2 to 2.4 months of imports of goods and services. In addition to implementing the many reforms scheduled for January 1, 2004, the government will take additional measures to ensure the sustainability of high levels of economic growth and a reduction in the incidence of poverty.

A. Fiscal Policy

12. The fiscal program for 2004 reaffirms the government's commitment to expand social services, develop Cape Verde's infrastructure, and foster private sector-led economic growth, while providing the necessary support to monetary policy. Revenue is conservatively projected to rise by only 4½ percent to CVEsc 18.4 billion (21 percent of GDP), reflecting the impact of the lower corporate income tax and special one-off operations in 2003. Excluding these factors, revenue is projected to increase in line with nominal GDP. Total expenditure is programmed to rise by 6.3 percent to CVEsc 28.2 billion (32.2 percent of GDP), with much of the increase going to hiring new teachers and doctors and raising their pay scale. Thus, the fiscal deficit (excluding grants) will be broadly unchanged relative to 2003, and the government will continue to run a sizable, though smaller, primary recurrent surplus, projected at 2½ percent of GDP.

13. The government's gross external financing requirement (grants plus loans) will be on the order of €110 million for 2004. While the budget is fully financed for the first half of 2004, some €26 million in budget support, most of which has already been identified, will be needed in order to help support the government's poverty reduction strategy. The government expects to convene a roundtable conference in mid-2004 to present its PRSP to the donor community and to help secure financing for its implementation.

14. With regard to tax reform, the government will focus its efforts on ensuring that the VAT and new customs tariff structure are fully implemented by the beginning of the year. These reforms will eliminate exemptions on import-based consumption taxes. While the government supports certain tax exemptions in high-priority sectors and for diplomatic missions in Cape Verde, it is aware that the resource demands arising from the implementation of the PRSP necessitate a rationalization of the current system of exemptions and a reduction in their number. This issue is being addressed in the context of our growth and competitiveness project, financed by the World Bank, and the completion of a

comprehensive assessment of the cost of exemptions would be a structural benchmark under the program. To enhance transparency and accountability, and to better inform the national debate on economic policy, the government will begin submitting quarterly reports of fiscal operations to the National Assembly by end-June 2004. This would also constitute a structural benchmark under the program.

B. Monetary and Financial Sector Policies

15. Given the recent softness in the balance of payments and the crucial importance of international reserve coverage to investor confidence and the sustainability of the exchange rate peg, the BCV will not ease monetary policy until a clear upward trend in reserves has been established. Broad money growth is expected to fall to 8-9 percent by the end of 2003 and to remain near 8 percent through 2004, in line with nominal GDP. Growth in credit to the economy is projected to expand on the order of 10-13 percent. Strict adherence to the 2004 fiscal program and success in obtaining the necessary budget support from our development partners will reduce the need for government borrowing from the banking system and establish the conditions for a gradual decline in domestic interest rates consistent with the rebuilding of international reserves.

16. The BCV is implementing a number of projects to strengthen its own operations and its oversight of the institutions it regulates. It is also seeking technical assistance in implementing the few remaining steps needed to complete compliance with the Fund's safeguards assessment report. Regulations have been issued to implement the Law on Money Laundering, including permitting the seizure of assets of suspected terrorists. On-site examinations have been completed for two domestic banks and one insurance company so far this year, and the rest will be completed in 2004. The BCV continues to monitor financial institutions through its monthly off-site reporting system. The BCV will also continue to license qualified banks and other financial institutions in order to increase competition and promote the development of a competitive financial sector, both on- and offshore.

C. Private Sector Competitiveness and External Sector Policies

17. Private-sector-led economic growth is a crucial component of Cape Verde's poverty reduction strategy and external viability. It is the government's objective to promote exports, especially of manufactured goods, tourism, and transportation services, and to attract a higher level of foreign direct investment and other private capital inflows. This strategy will require a dynamic and competitive private sector. The government's public investment program will continue to focus on improving transport and other infrastructure, but structural reforms, human development, legal reforms, and investment promotion will all be necessary to achieve these objectives. These issues are being addressed in the context of the government's growth and competitiveness project.

18. Critical to the government's strategy is the reform of large enterprises providing public services that are either owned or regulated by the state. These enterprises have imposed unnecessary costs both on the budget and on domestic entrepreneurs. While

substantial progress in reforming these companies has been made already, additional steps will be taken in this area during the first half of 2004 that will serve as benchmarks and performance criteria (where indicated) for the PRGF-supported program:

- An action plan has been adopted to make the ARE operational by the beginning of 2004, and technical assistance is being provided to help develop the regulatory framework. By end-June 2004, the ARE will issue regulations establishing the methodology for determining electricity and water tariffs (benchmark).

- As a continuous structural performance criterion under the program, no subsidy will be paid to Electra until the government and Electra sign a memorandum of understanding clearly identifying which remote rural power facilities qualify for the subsidy agreed in the memorandum of understanding (MOU) with Electra dated July 17, 2003. The MOU will also specify that no subsidy will be paid until Electra provides the government with records of gas oil consumption in the identified facilities and until these records are verified by an auditor appointed by the government.

- In preparation for privatization, and with financial assistance from the World Bank, the government will appoint a specialized international management team for TACV to complete the operational restructuring of the company and negotiate with potential partner airlines. An invitation to bid on the management contract will be issued by end-March 2004. As a continuous performance criterion under the program, no subsidies will be paid to TACV.

- Interbase and the remaining ships of Arca Verde (the interisland maritime transport service, which is in liquidation) will be offered for bid in December 2003. The government expects to complete the process of selecting buyers during the second quarter of 2004.

19. The government is making every effort to finance its poverty reduction strategy with loans containing a grant element of at least 35 percent and with grants. However, Cape Verde's' rising per capita income has led some creditors to graduate the country from their highly concessional lending programs. The government has negotiated, but not signed, two loans with the OPEC Fund for International Development to finance the construction of schools and health centers in some of the country's poorer regions. The proposed loans contain a grant element of about 29 percent, somewhat lower than the threshold established under the PRGF arrangement (35 percent grant element), though still in keeping with the government's emphasis on prudent debt management. Given the importance of these projects, the high grant element of the loans, and their compatibility with external debt sustainability, the government requests that the cumulative ceiling on nonconcessional borrowing from December 2003 onward be lifted from zero to $10 million in order to accommodate these credits.

V. Program Monitoring

20. Program implementation through June 2004 will be monitored according to the performance criteria and benchmarks presented in Tables 1 and 3. The definition of the variables monitored as quantitative performance criteria and benchmarks and reporting requirements remain as set forth in the technical memorandum of understanding (TMU) for the second review of the PRGF appended to the memorandum of economic policies for the second review under the PRGF (June 9, 2003). The TMU has been amended to incorporate the projected disbursements of budget support and payments of external debt service through June 2004, on which the program adjusters will be based. The fourth review will be conducted by May 31, 2004.

Table 1. Cape Verde: Quantitative Performance Criteria and Benchmarks Under the PRGF-Supported Program, 2003-04

	2002	Cumulative flows from End-December 2002								
		2003							2004	
	Dec.	March	June			Sep.	Dec.		March	June
	Level	Estimate	Performance criteria	Performance criteria (adjusted)	Estimate	Indicative target	Perform. criteria	Performance criteria (modified)	Indicative target	Performance criteria
Quantitative targets 1/ 2/					(In billions of Cape Verde escudos)					
Ceiling on net domestic credit to the central government from the banking system 3/ 4/	14.4	-0.2	0.0	0.0	0.3	0.2	0.5	1.3	2.0	1.7
Ceiling on net domestic assets of the central bank 3/	7.6	0.6	0.4	0.4	1.0	0.1	0.2	0.2	0.6	0.2
Ceiling on the accumulation of new domestic payment arrears by the central government	1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
					(In millions of U.S. dollars)					
Ceiling on the accumulation of new external debt arrears by the central government 5/	...	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/ 6/	...	0.0	0.0	0.0	0.0	0.0	0.0	10.0	10.0	10.0
Ceiling on the outstanding stock of nonconcessional external debt with a maturity of less than one year by the central government 5/ 7/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
					(In millions of euros)					
Floor on net international reserves of the Bank of Cape Verde (BCV) 8/	72.4	1.0	0.4	0.3	-1.3	4.7	2.9	2.9	4.9	7.9
					(In billions of Cape Verde escudos)					
Floor on the primary current fiscal balance (indicative target)	...	...	2.2	2.2	0.9	3.4	4.7	3.1	3.1	3.4
Program assumptions										
Nonproject external financial assistance	...	0.9	1.4	...	1.2	1.8	1.9	1.9	2.5	3.5
External debt service 9/	...	0.4	1.2	...	1.0	1.8	3.1	2.7	3.3	4.1
Cash payments of domestic arrears	...	0.0	0.0	...	0.0	0.3	0.4	0.4	0.0	0.0

1/ Quantitative performance criteria and benchmarks are described in the technical memorandum of understanding (Attachment II).
2/ For purposes of calculating program adjusters, actual debt service payments and actual nonproject external financial assistance will be valued at current exchange rates.
3/ 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. For purposes of calculating the adjusters, these flows will be valued at current exchange rates.
4/ The ceiling on net domestic credit to the central government from the banking system will be adjusted downward by the shortfall in cash payments of domestic arrears relative to program assumptions.
5/ This performance criterion is on a continuous basis.
6/ This performance 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 to commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are rescheduling arrangments, the Portuguese credit line, and borrowings from the Fund. The grant element of any nonconcessional external debt under this ceiling shall not fall short of 15 percent.
7/ 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 arrangments, the Portuguese credit line, borrowings from the Fund, and normal import-related credits.
8/ The floor on net international reserves of the Bank of Cape Verde 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.
9/ Beginning at end-December 2003, external debt service projections have been corrected downward by CV Esc 550 million to eliminate the double counting of projected repayments of the Portuguese credit line, which are recorded in projected nonproject external financial assistance.

Table 2. Cape Verde: Structural Performance Criteria and Benchmarks Under the Second Annual Program Supported by the PRGF Arrangement

Measures	Test Dates	Status or Amended Test Dates
Structural performance criteria		
Approval by the Council of Ministers of the VAT pre-registration decree	June 2003	Done
Structural performance benchmarks		
Approval by the Council of Ministers of the amended National Accounting Plan	September 2003	Done
Inclusion of VAT and external tariff reform in 2004 budget	October 2003	Done
Approval by the Council of Ministers of the decree establishing the multisector regulatory agency	September 2003	Done

Table 3. Cape Verde: Supplementary Structural Performance Criteria and Benchmarks Under the Second Annual Program Supported by the PRGF Arrangement

Measures	Test Dates	Status or Amended Test Dates
Structural performance criteria		
Refrain from providing budgetary subsidy to Electra until MOU on monitoring is signed	Continuous	
Refrain from providing budgetary subsidy to TACV	Continuous	
Structural performance benchmarks		
Complete comprehensive assessment of the cost of all tax exemptions and incentives	June 2004	
Adopt regulations establishing the methodology for determining electricity and water tariffs at the Economic Regulatory Agency	June 2004	
Submit report of fiscal operations for first quarter of 2004 to the National Assembly	June 2004	

Cape Verde: Technical Memorandum of Understanding for the Second Annual Program Under the PRGF Arrangement

1. This memorandum sets out the understandings between the Cape Verdean authorities and the IMF staff regarding the definition of the quantitative performance criteria and indicative targets and reporting requirements under the second annual program supported by the Poverty Reduction and Growth Facility (PRGF) arrangement.

I. Quantitative Performance Criteria and Indicative Targets[1 2]

A. Government Finances

2. Total government revenue is defined as the sum of all tax and nontax revenues, domestic capital participation, and net lending, cumulative since the start of the calendar year, excluding privatization proceeds and external grants. Tax revenue and nontax revenue are defined in accordance with the *Government Finance Statistics Manual (GFS)* 1986, Section IV.A.1.

3. The floor on the primary current fiscal balance cumulative from the beginning of calendar-year 2003 constitutes an indicative performance target. The primary current fiscal balance is defined as the difference between total government revenue (defined above in para. 1) and current primary expenditures on a commitment basis. Current primary expenditures equal total government expenditures on a commitment basis less interest obligations on external and domestic debt, capital expenditures, extraordinary expenditures on social emergency measures, and retrenchment payments made as part of the public enterprise privatization and liquidation reform.

4. For the purposed of this memorandum, privatization 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 liquidation of a public company, less restructuring costs.

5. **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

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[1] See Table 1 of the memorandum on economic and financial policies (MEFP).

[2] The data source used to evaluate the performance criteria on net domestic credit to the central government, net domestic assets of the central bank, and net international reserves will be the Cabo Verde—Panorama Bancario tables prepared monthly by the Bank of Cape Verde (BCV) Statistics and Research Department and forwarded electronically to the IMF African and Statistics Departments.

revenue by category, including external budget support grants; (ii) government expenditure, including primary current expenditure, domestic and external interest payments, and capital expenditure, including domestic capital expenditure and estimates of externally financed capital expenditure; (iii) the gross payment and gross accumulation of domestic payments arrears; (iv) external loan receipts and principal payments; (v) external arrears payments and accumulation; (vi) bank and nonbank financing; (vii) privatization receipts; and (viii) any other revenue, expenditure, or financing not included above.

B. Net Domestic Assets of the Central Bank

6. The ceiling on the cumulative change, from the beginning of calendar-year 2003, in net domestic assets of the Bank of Cape Verde (BCV) constitutes a performance criterion. Net domestic assets (NDA) of the BCV are defined as reserve money minus net foreign assets of the BCV, evaluated at the program exchange rates presented below. 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. Net Bank Credit to the Central Government

8. The ceiling on the cumulative change, from the beginning of calendar-year 2003, in net credit to the central government from the banking system constitutes a performance criterion. Net credit to the central government from the banking system (NCCG) is defined as the overall position of the main central government institutions vis-à-vis the banking 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 and by commercial banks, less all deposits held by the central government with the central bank and with commercial banks, as they are reported monthly by the BCV to the IMF. The INPS (the social security agency) is not included in central government accounts. Net bank credit to the central government excludes claims on the Trust Fund (TCMFs).

9. Claims on the central government held by the central bank comprise the following items: (i) *crédito conta corrente OGE*; (ii) *Tesouro público protocolo*; (iii) *títulos governo central—obrigações nova serie*; (iv) *créditos a regularizar m/n e m/e*; (v) *outros créditos ao governo*; and (vi) any other claims, or claims on the central government to be regularized, held by the central bank.

10. Deposits held by the central government with the central bank comprise the following items: (i) *depósitos do governo central—depósitos a ordem m/n*; (ii) *depósitos do governo central—depósitos a ordem m/e*; and (iii) *outros depositos do governo central.*

11. Claims on the central government held by the commercial banks comprise the following items: (i) *obrigações do Tesouro*; (ii) *bilhetes do Tesouro*; (iii) *protocolos*; (iv) *empréstimos*; (v) *outros títulos;* (vi) *outros créditos*; and (vii) any other claims, or claims on the central government to be regularized, held by the commercial banks.

12. Deposits held by the central government with the commercial banks comprise the following items: (i) *dep. governo central em m/n*—D.G.T.; (ii) *dep. governo central em m/n—serviços autónomos*; (iii) *dep. governo central em m/n—fundos autónomos*; (iv) *dep. governo central em m/n—projectos de investimentos*; (v) *dep. governo central em m/n—fundos de contrapartida*; (vi) *dep. governo central em m/n—institutos c/autonomia administ. e financeira excepto INPS*; (vii) *dep. governo central em m/e*; and (viii) *outros passivos com o governo.*

13. The program ceilings for the NCCG 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. In addition, the ceilings for the NCCG will be adjusted downward by the shortfall in cash payments of domestic arrears relative to program assumptions.

14. **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.

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

15. Under the program, ceilings on medium- and long-term, as well as on short-term, nonconcessional external debt constitute performance criteria. These performance 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 Table 1 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 performance 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 performance 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).

16. **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 performance 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.

E. Net International Reserves of the Central Bank

17. The floor on the cumulative change, from the beginning of calendar-year 2003, in net international reserves (NIR) of the BCV constitutes a performance criterion under the program. The NIR of the BCV are defined as gross international reserves of the BCV net of its short-term external liabilities, calculated at the program exchange rates described below. Gross reserves of the BCV are those that are readily available (i.e., liquid and marketable and free of any pledges or encumberments), 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.

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

F. Nonaccumulation of New Domestic Payments Arrears

19. 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 as has been 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. The outstanding stock of domestic payments arrears at end-December 2002 is estimated at CVEsc 1.1 billion.

20. **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.

G. Nonaccumulation of External Payments Arrears

21. 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.

22. External arrears are defined as total external debt-service obligations of the government that have not been paid by the time they are due, unless the definition of an arrear has been defined contractually between the government and creditor. External arrears exclude arrears on external debt, pending the conclusion of debt-rescheduling agreements. The outstanding stock of external arrears at end-December 2002 amounted to US$7.5 million.

23. **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.

H. Program Exchange Rates and Nonproject Budgetary Support

24. Performance under the program will be assessed based on program exchange rates. The program exchange rates for this purpose are as follows:

CVEsc 110.3 = €1; CVEsc 0.55 = Esc 1 (Portuguese escudos); and CVEsc 147.9 = SDR 1.

25. The 2003-04 program assumes (i) €5 million in nonproject budget support from the European Union in the first quarter of 2003 and €6 million in the second quarter of 2004; (ii) US$4 million in nonproject budget support from the World Bank in the first quarter of 2003; (iii) US$6.2 million in nonproject budget support from the African Development Bank, comprising US$3.2 million in the third quarter and US$3 million in the fourth quarter of 2003; (iv) US$2 million from the Netherlands in the fourth quarter of 2003 and €3 million in the second quarter of 2004; and (v) the repayment of the outstanding Esc 200 million from the Portuguese credit facility drawn in 2002 and the drawing of Esc 1 billion from the Portuguese credit facility in the second quarter of 2003, of which Esc 800 million will be repaid in the fourth quarter of 2003; a further drawing of Esc 1 billion is assumed for the first quarter of 2004.

II. Other Data Requirements for Program-Monitoring Purposes

26. 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.

27. 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.

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

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December 19, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Third Review Under Cape Verde's PRGF Arrangement and Approves US$1.8 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) completed today its third review of Cape Verde's economic performance under an SDR 8.64 million (about US$12.7 million) Poverty Reduction and Growth Facility (PRGF) arrangement (see Press Release No. 02/18). The completion of this review enables the release of a further SDR 1.23 million (about US$1.8 million), which would bring the total amount drawn under the arrangement to SDR 4.92 million (about US$7.2 million).

Cape Verde's three-year PRGF arrangement was approved on April 10, 2002 for SDR 8.64 million (about US$12.7 million). So far, Cape Verde has drawn SDR 3.69 million (about US$5.4 million) under the arrangement.

The PRGF is the IMF's concessional facility for low income countries. PRGF-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 PRGF-supported programs are consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent and are repayable over 10 years with a 5 ½-year grace period on principal payments.

After the Executive Board's discussion on Cape Verde, Agustín Carstens, Deputy Managing Director and Acting Chairman, stated:

"The Cape Verde authorities' have taken corrective action to address the macroeconomic slippages of the first half of the year. Economic growth remains strong, inflation continues to be low, and progress is being made in establishing conditions for higher rates of private sector-led economic growth. The authorities have continued their impressive pace of structural reforms. However, the stock of international reserves remains too low to provide an adequate buffer against recurrent shocks, and the accumulation of reserves during the first nine months of 2003 was generally slower than envisaged. It is therefore important to orient monetary policy toward a continued accumulation of international reserves. In this regard, the recent tightening of monetary policy should help to maintain confidence in the exchange rate peg.

"The authorities' proposed macroeconomic policy mix for 2003-04 strikes an appropriate balance between the need to move ahead with implementing the poverty reduction strategy and the need to ensure adequate fiscal support for the accumulation of international reserves. The program for 2004 allows for the continued expansion of education and health services, a modest increase in international reserve coverage, and adequate growth in credit. This will require budget support from Cape Verde's development partners.

"The authorities should prepare a high-quality PRSP as quickly as possible. It will provide the opportunity to prioritize and cost their policies, and help ensure that the level of public spending is consistent with accelerating economic growth and poverty reduction, while preserving macroeconomic stability. It will be particularly important for the authorities to set clear and attainable targets for expenditures in public education and health, given the dominance of these sectors in the central government wage bill. The authorities should make every effort to limit future external financing of their poverty reduction strategy to grants and highly concessional loans in order to increase poverty-reducing expenditures without endangering external debt sustainability.

"Progress in implementing structural reforms has been commendable, including reduced financial losses in public enterprises and preparations to implement a VAT and new customs tariffs on January 1, 2004. Making the new Economic Regulatory Agency fully operative will be essential to ensuring the profitability and efficiency of public utilities, which, in turn, will be key to reducing the need for budgetary support and promoting private sector growth," Mr. Carstens stated.

Statement by Damian Ondo Mañe, Executive Director for Cape Verde
December 19, 2003

My Cape Verdean authorities are thankful to the Fund for the ongoing support to the country. They particularly appreciate staff's constant and helpful advice provided since the beginning of the current PRGF arrangement. The authorities remain committed to the implementation of the comprehensive program of economic and structural reforms. The economic performance during the first half of 2003 was broadly satisfactory amid adverse external conditions: economic growth remains strong and inflation is subdued. The authorities have made significant efforts towards maintaining macroeconomic stability and the prospects for 2004 as well as the medium term are fairly good.

While impediments to sustained growth are being alleviated, including the debt burden, the economy of Cape Verde remains vulnerable to unfavorable external shocks and faces low absorptive capacity. Weak economic activity and technical factors caused a revenue shortfall, which resulted in the nonobservance of three quantitative performance criteria. Corrective actions have been taken, and my authorities are requesting waivers for the missed performance criteria. All structural performance criteria and benchmarks through October 2003 were observed.

Recent Performance is Fundamentally Positive

Although weaker than expected due to an adverse external environment for tourism, economic growth in the first half of 2003 remains positive, and is expected to show improvement during the second half of the year, owing to the recovery of the agricultural sector, exports and tourism. Indeed, the program's growth objective of 5.0% is likely to be met. As for inflation, it has been under control (2 %) with the help of the country's exchange rate peg regime. The program's inflation target has been revised downward, taking account of the success of the exchange regime as well as the measures taken to correct the fiscal slippages observed earlier this year.

The continued strengthening of the euro vis-à-vis the U.S. dollar has resulted in the appreciation of the real effective exchange rate of Cape Verde's escudo, which is pegged to the euro. However, this appreciation has not altered the external competitiveness of the Cape Verdean economy. In addition, the country's terms of trade are projected to improve in 2003 after last year's deterioration.

As regards the program conditionality, the Cape Verdean authorities' commitment to prudent debt management has led to the observance of all four quantitative performance criteria related to the domestic and external debt by end-June 2003. Specifically, there was no new accumulation of domestic or external debt of the central government; nor did they exceed the two ceilings on nonconcessional external debt.

The three quantitative performance criteria that were not met in end-June are all related and should be regarded as the corollary of the same exogenous factor. Indeed, their nonobservance stems from a government revenue shortfall that mirrored the weak economic activity in the first half of 2003. Given the insufficient leeway on the savings side, the revenue hardship was circumvented by drawing down deposits at the central bank (BCV), which resulted in not meeting the program criteria on net bank credit to the government, net domestic assets of the BCV and net international reserves. However, the authorities have taken corrective actions to address these slippages, including the provision of incentives for the timely payment of taxes as well as those intended to the tax administration to boost the collection of tax penalties.

My authorities have pursued the structural reforms envisaged under the program, and as noted above all structural performance criteria and benchmarks through October were met. In particular, significant progress has been made to reduce the financial losses of the state-owned enterprises. As regards the subsidies to certain public enterprises (the airline TACV, the inter-island maritime transporter Arca Verde, and the fish-freezing facility Interbase) early in the year, these were part of the efforts aimed at cutting unprofitable routes, ensuring the provision of service to remote locations and better preparing the conditions for the privatization of these companies. The strategic importance of these enterprises is well described in Box 1 of the staff report, and the authorities are pursuing their efforts aimed at their privatization which should help alleviate the financial burden on the government resources and favor the more effective and efficient provision of critical services.

The BCV has significantly advanced the implementation of the recommendations of the safeguards assessment report, including the external and internal auditing functions, the reorganizing of the foreign exchange management, the enhancement of internal control mechanism, and transparency with the publication of last year's audited accounts. It has made progress towards implementing the accounting and financial reporting requirements under the auspices of the International Accounting Standards (IAS).

The Medium-Term Outlook Remains Bright

The medium-term projections are based on realistic assumptions, which do not diminish the positive outcome of the outlook. My authorities are committed to fiscal consolidation and medium-term macroeconomic stability. On the one hand, they intend to pursue a prudent fiscal policy stance. On the other hand, there are good reasons to believe that the structural reforms underway to improve economic efficiency through the progressive elimination of price distortions, the privatization processes, and the remarkable government debt management will pave the way to sustainable growth and the successful implementation of poverty reducing measures.

Although relatively low, the net international reserves position of Cape Verde has been improving steadily; the credit to the economy has become the largest contributor to broad money growth; and domestic investment is slowly closing the gap with government expenditures as shares of GDP. My authorities expect that the sound macroeconomic policies they are following will be conducive to a sustained economic growth.

Furthermore, the debt sustainability analysis (DSA) clearly shows that all external debt ratios are expected to decline to comfortable levels over the medium term, and that should help to strengthen the financial position of the country.

Modification of Program Quantitative Performance Criteria

While remaining current on its external debt service obligations, Cape Verde has cleared all external debt arrears to multilateral creditors and rescheduled arrears with most of bilateral creditors. The authorities are currently in negotiations with the remaining two bilateral creditors for rescheduling plans. The results of these remarkable efforts of debt rescheduling favor the sustainable debt burden described above. However, there are infrastructure and social demands that require external borrowing. My authorities have negotiated two important loans with the OPEC Fund for International Development, totaling US$10 million for the construction of schools and health facilities in rural areas. These loans, which would secure about 29% of grant element, would not meet the minimum 35% grant requirement under the program. My authorities request a modification of the related performance criterion, in view of the fact that the loans are intended to support the ongoing poverty reduction efforts. This borrowing has been incorporated in the DSA conducted by staff, and will not affect the country's debt sustainability ratios.

My authorities also request a modification of the performance criterion on the ceiling on net bank credit to the government for end-December, to take account of the programmed reduction in domestic arrears amid the revenue shortfall, which leaves little scope outside additional bank financing during the last quarter of 2003. The recourse to this additional bank credit will not dramatically affect the government domestic indebtedness as its domestic debt-to-GDP ratio will continue to decline.

A Comprehensive Program Through 2004

As Cape Verde faces the challenges ahead, it will require the full support of partners, including the Fund. My authorities are committed to the implementation of the ongoing program of economic stabilization and reform as confirmed and enhanced in their Memorandum of Economic and Financial Policies (MEFP). The program for 2004 includes the continued implementation of reform measures intended to ensure strong economic growth and poverty reduction.

Fiscal Policy

The government will increase social services, expand the country's infrastructure base, and promote growth based on the development and buoyancy of the private sector. The programmed increase in expenditures will go in large part to the recruitment of new teachers and doctors, as well as to the increase of the pay scale in these two categories of civil servants. These demands will be met within the fiscal framework established under the program.

The authorities will spare no efforts to improve government accountability and transparency, by informing the public of the economic policy and beginning to report the fiscal operations to the national representation by end-June.

Monetary and Financial Sector Policies

The central bank of Cape Verde will pursue its important reforms to improve the effectiveness of its operations and supervision tasks. At the same time, it is requesting Fund's technical assistance to implement some measures related to the safeguards assessment report. The BCV also aims to improve the intermediation functions of the institutions it supervises by promoting onshore as well as offshore banking competition.

Structural Reforms

The government's strategy to promote the private sector and its competitiveness is clearly outlined in its Growth and Competitiveness Project. My authorities are cognizant of the necessity to establish private sector-led growth as the core factor to ensure persistent poverty reduction. A competitive and vigorous private sector will substantially contribute to promote the exports of the country's traditional products and services, including tourism, transportation, and manufactured goods, and to attract more direct investment. The continuation of the reform of public service enterprises highlighted above will be a core component of this approach.

The authorities have adopted an action plan to make the Economic Regulatory Agency (ARE) operational by early 2004. In this respect, the authorities receive technical assistance to help develop the regulatory framework. ARE will be in charge of adjusting electricity and water tariffs following changes in production costs, and augmenting Electra's efficiency. The authorities have committed to not paying subsidies to the electrical and water company until the two parties sign a supplementary memorandum of understanding identifying the rural facilities that qualify for the financial assistance. Finally, the processes of privatization of TACV on the one hand and Interbase and Arca Verde on the other hand, are under preparation and the selection of buyers should be completed by end-March and the second quarter of 2004, respectively. The authorities have pledged not to pay subsidies to TACV.

The PRSP Process

As regards the PRSP process, the government intends to pursue the development of the medium-term expenditure framework for 2004-2006 initiated with the help of donor assistance. The establishment of the PRSP steering committee has put the process back on track. The final draft of the PRSP document is expected by March 2004. My authorities will make their utmost effort to the production of a high-quality document and follow the advice of the Fund and World Bank to ensure the success of its poverty reduction strategy.

Conclusion

Cape Verde has achieved important progress in the implementation of its reform agenda. Despite some slippages that occurred under the present arrangement, and to which corrective measures have been duly taken, Cape Verde has a strong record of policy implementation, and the authorities are committed to the pursuit of the reforms necessary for the country to achieve high and sustainable growth and to reduce significantly the incidence of poverty. In that context, my authorities are hopeful that the international community will continue to strongly support their efforts, and I will very much appreciate the Board's approval of the proposed decision.