INTERNATIONAL MONETARY FUND

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Cape Verde: First Review Under the Policy Support Instrument—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Cape Verde

In the context of the first review under the Policy Support Instrument, the following documents have been released and are included in this package:

- the staff report for the First Review Under the Policy Support Instrument, prepared by a staff team of the IMF, following discussions that ended on November 14, 2006, with the officials of Cape Verde on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 22, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;

- a Press Release summarizing the views of the Executive Board as expressed during its January 22, 2007 discussion of the staff report that completed the review; and

- a statement by the Executive Director for Cape Verde.

The documents 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 *

*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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INTERNATIONAL MONETARY FUND

CAPE VERDE

First Review Under the Policy Support Instrument

Prepared by the African Department

(In consultation with other departments)

Approved by David Nellor and Mark Plant

December 22, 2006

- **Fund relations:** The Board discussed the 2006 Article IV consultation and request for a three-year Policy Support Instrument (PSI) on July 31, 2006. Cape Verde's use of Fund resources stood at SDR 8.64 million (90 percent of quota) on October 31, 2006. Cape Verde has accepted the obligations under Article VIII of the Articles of Agreement and maintains a fixed exchange rate that is free of restrictions in the making of payments and transfers for current international transactions.
- **The PSI:** Seeks to reduce macroeconomic risks, provide a margin of safety against exogenous shocks, and address the prospect of a longer-term decline in highly concessional external support. Priority measures are (i) reducing public debt; (ii) building up international reserves; (iii) rationalizing the system of tax exemptions; (iv) implementing the automatic mechanism to adjust electricity and water tariffs; (v) improving public financial management; and (vi) strengthening capacities and regulation in the financial sector.
- **Performance:** Economic and policy performance remains strong. Growth projections for 2006 and 2007 have been revised upward, international reserves are accumulating rapidly, and inflation is falling more quickly than expected. The authorities reaffirm their commitment to the PSI policy objectives. They request two waivers of assessment criteria; based on the firm corrective actions being taken in both cases, the staff supports the requests for waivers.
- **Currency:** Cape Verde escudo, pegged to the euro at a rate of CVEsc 110.3 per €1 since 1999.
- **Discussions:** October 31–November 14, 2006. The staff team comprised Mr. MacFarlan (head), Mr. Maehle, Mr. Franken, and Mr. Fabig (all AFR). Ms. Francisco of the World Bank accompanied the mission. The team met with the new Minister of Finance and Public Administration Cristina Duarte, Governor of the Bank of Cape Verde Carlos A. D. De Burgo, other officials, and representatives of commercial banks, the energy sector, trade unions, and the donor and diplomatic communities.
- **Publication:** The authorities have agreed to publish this staff report, the Letter of Intent, and the updated Memorandum of Economic and Financial Policies.

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EXECUTIVE SUMMARY

Recent Developments and Program Performance

- **Cape Verde's economic and policy performance remains strong.** Growth projections for 2006 and 2007 have been revised upward and inflation is falling faster than expected.

- **Fiscal and monetary policy developments in 2006 are on track** to substantially surpass the program objectives of reducing domestic debt as a share of GDP and building up international reserves.

- **Two assessment criteria were missed.** The government has not been able to fully prevent accumulation of new domestic arrears and, owing to a change in the ownership of the electricity and water company, full implementation of the automatic adjustment mechanism for electricity and water tariffs has been delayed.

Policy Discussions and Staff Appraisal

- **The authorities reaffirm their commitment to the PSI policy goals.** Their macroeconomic and structural reform objectives for 2007 are fully consistent with the program agreed when the PSI began.

- **The budget for 2007 reinforces the government's commitment to fiscal discipline.** Government domestic borrowing is set to be lower than initially targeted. The program goal of reaching a domestic debt ratio of 20 percent of GDP by 2009 is likely to be reached ahead of schedule.

- **The authorities are acting decisively to strengthen fiscal policy formulation, implementation, and control,** including through measures to end the accumulation of public sector payment arrears.

- **Monetary and financial sector policies focus on increasing reserve cover further, strengthening the operating framework for monetary policy, and ensuring that conditions for financial sector development are consistent with best practice.**

- **With Electra again under state ownership, the government is moving forcefully to strengthen the company's commercial operations and support its investment strategy.** The government also intends to improve the mechanism for adjusting retail fuel prices.

- **Staff supports completion of the program review.** Based on the corrective actions being taken and the quality of the authorities' policies, staff also supports their request for waivers.

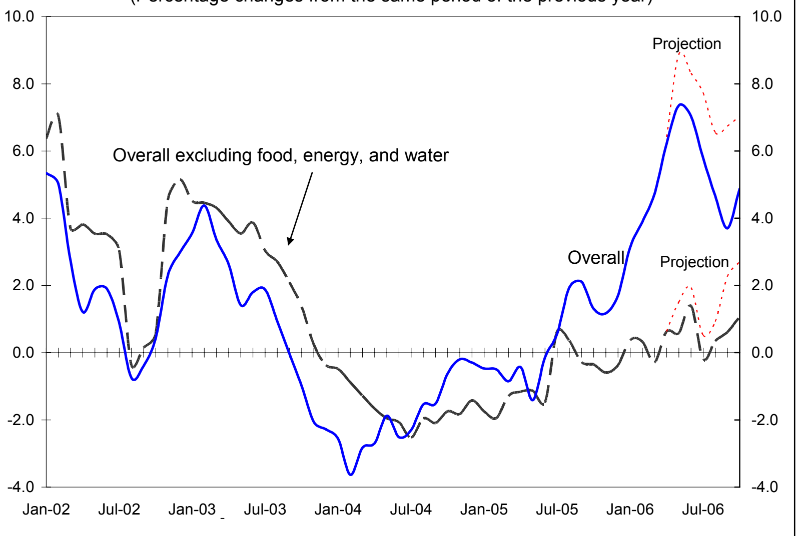
I. Background

1. **The PSI-supported program is designed to help Cape Verde respond to the opportunities and challenges associated with the country's graduation from UN least-developed-country (LDC) status in 2008.** The program emphasizes reducing macroeconomic risks, increasing the margin of protection against exogenous shocks, and preparing for the prospect of a long-term decline in highly concessional external support. Over the next few years Cape Verde must continue to attract concessional support while also preparing to become less dependent on aid in the future. That can be done by further improving the business environment and hence drawing in more private capital.

II. Recent Developments and Performance Under the PSI

2. **Cape Verde's economic performance remains strong.** The tourism sector is developing rapidly, driven by significant growth in foreign direct investment (FDI) in hotels and other tourism-related construction: through the third quarter of 2006, tourism exports almost doubled and FDI increased by around 60 percent compared to the same period of 2005. Further support has come from public investment in infrastructure and better external transportation links. Moreover, business confidence—in the tourism area and in the economy generally—is high. While economic activity in 2006 may have been held back by difficulties with electricity supply during the summer and recent shortages in some construction sector inputs, the overall outlook for the year remains favorable: the growth projection has been revised up from 5.5 to 5.8 percent (see ¶13 below).

Figure 1. Cape Verde: CPI Inflation Rates, 2002–06
(Percentage changes from the same period of the previous year)



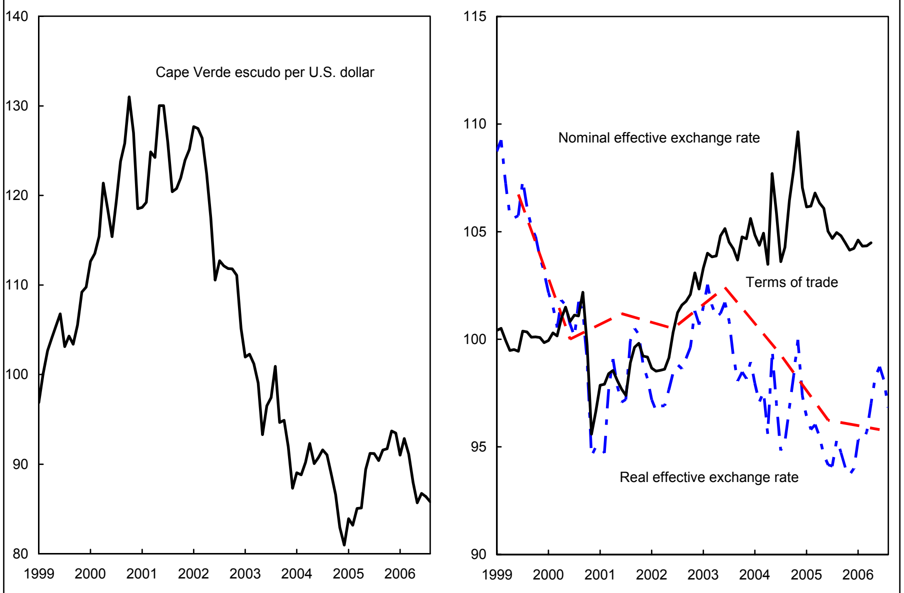
Sources: Cape Verdean authorities, and IMF staff calculations.

3. **Consumer inflation is falling after a short-lived upturn** (Figure 1). Though prices fell for much of 2003–05, they increased rapidly in the first part of 2006: the CPI rose by 7.4 percent in the year to May, mainly because higher international oil prices pushed up domestic energy and water prices, and there were temporary shortages of a few food items. With these influences now reversing, the 12-month inflation rate declined to below 5 percent in October. Excluding food, energy, and water, inflation in 2006 has been minimal, about 1 percent or less. Modest increases in private sector and civil service wages in 2006 helped contain second round effects of the inflation upturn. The recent fall in inflation is reflected in a downturn in the real effective exchange rate, partially reversing its increase earlier in 2006 (Figure 2).

4. **The international reserves of the Bank of Cape Verde (BCV) continue to grow strongly,** reflecting prudent monetary and fiscal policies (Figure 3). Reserve build-up through the third quarter of 2006 significantly exceeded the program target, reaching 3.2 months of prospective imports—up from 2.8 months at the end of 2005. Cape Verde has had continued success in attracting inflows of official assistance and, as noted above, tourism exports and FDI have picked up strongly in 2006. Inflows of remittances and emigrant deposits also held steady, even though the spread of the emigrant deposit rate against the euro area rate narrowed by 170 basis points.[1]

Figure 2. Cape Verde: Exchange Rates, 1999–2006

(Index, 2000 = 100)



Sources: International Financial Statistics, and Information Notice System.

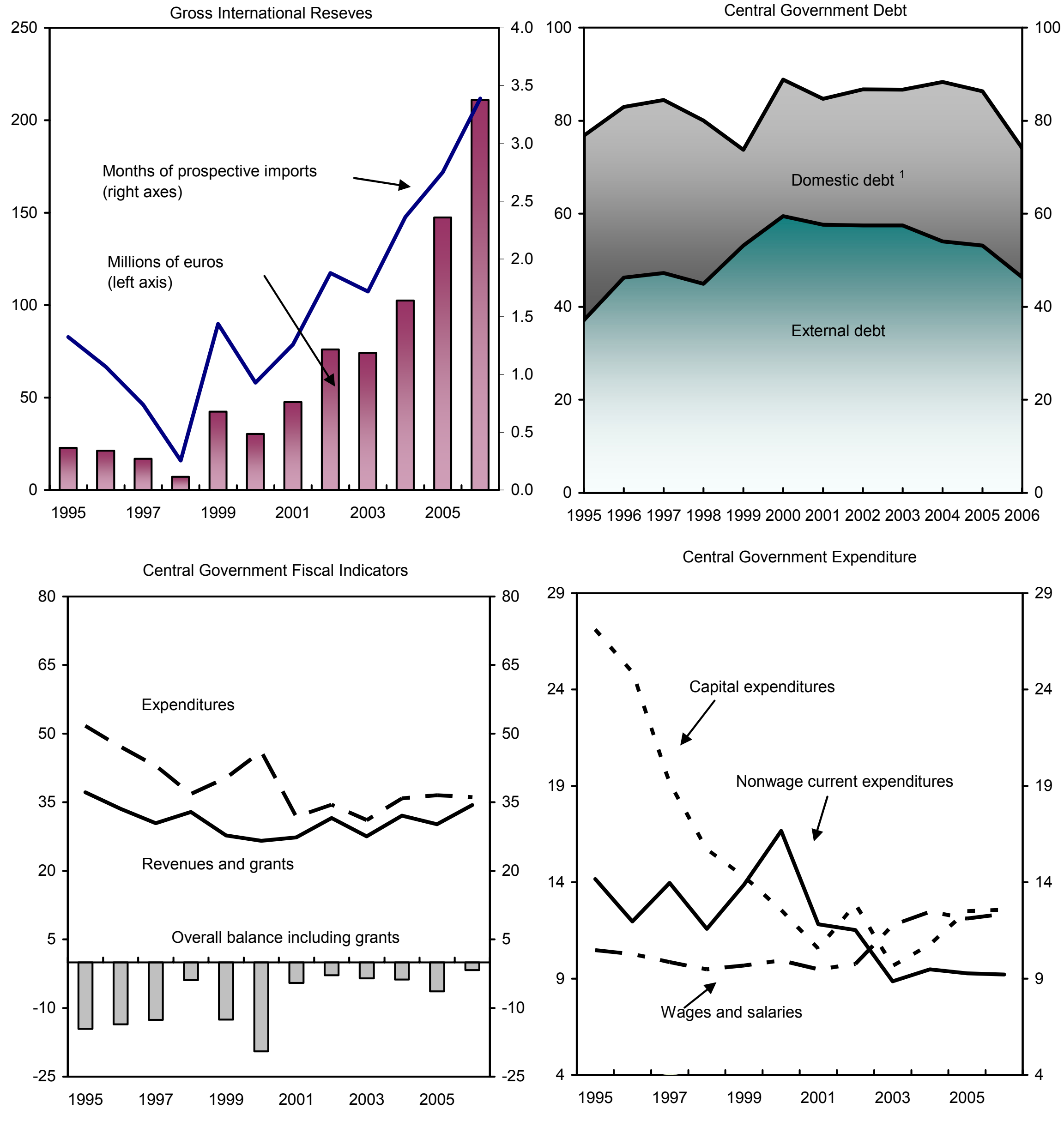
5. **Commercial banks' excess reserves have declined in recent months, but are still high.** Since mid-March 2006 the BCV has largely absorbed the liquidity effect of the reserve build-up by selling central bank securities, and the government has been reducing its net liabilities to the BCV. As a result, reserve money growth slowed considerably through October 2006 and contributed to a 100 basis point increase in treasury bill rates, which are again above short-term nonemigrant deposit rates.[2] Broad money growth, however, is well above nominal GDP growth (see ¶16). The commercial banks have responded to the excess liquidity by sharply increasing both their net foreign asset positions and their lending to the private sector (Figure 4). The latter growth largely reflects highly collateralized lending to the booming construction sector (based on volume rather than price growth), along with the development of new consumer credit facilities.

[1] The average emigrant deposit rate is currently 4.4 percent, 2 percent above the euro area deposit rate.

[2] Short-term nonemigrant deposit rates have declined by 80 basis points.

Figure 3. Cape Verde: Selected Macroeconomic Indicators, 1995–2006

(Percent of GDP, unless otherwise indicated)

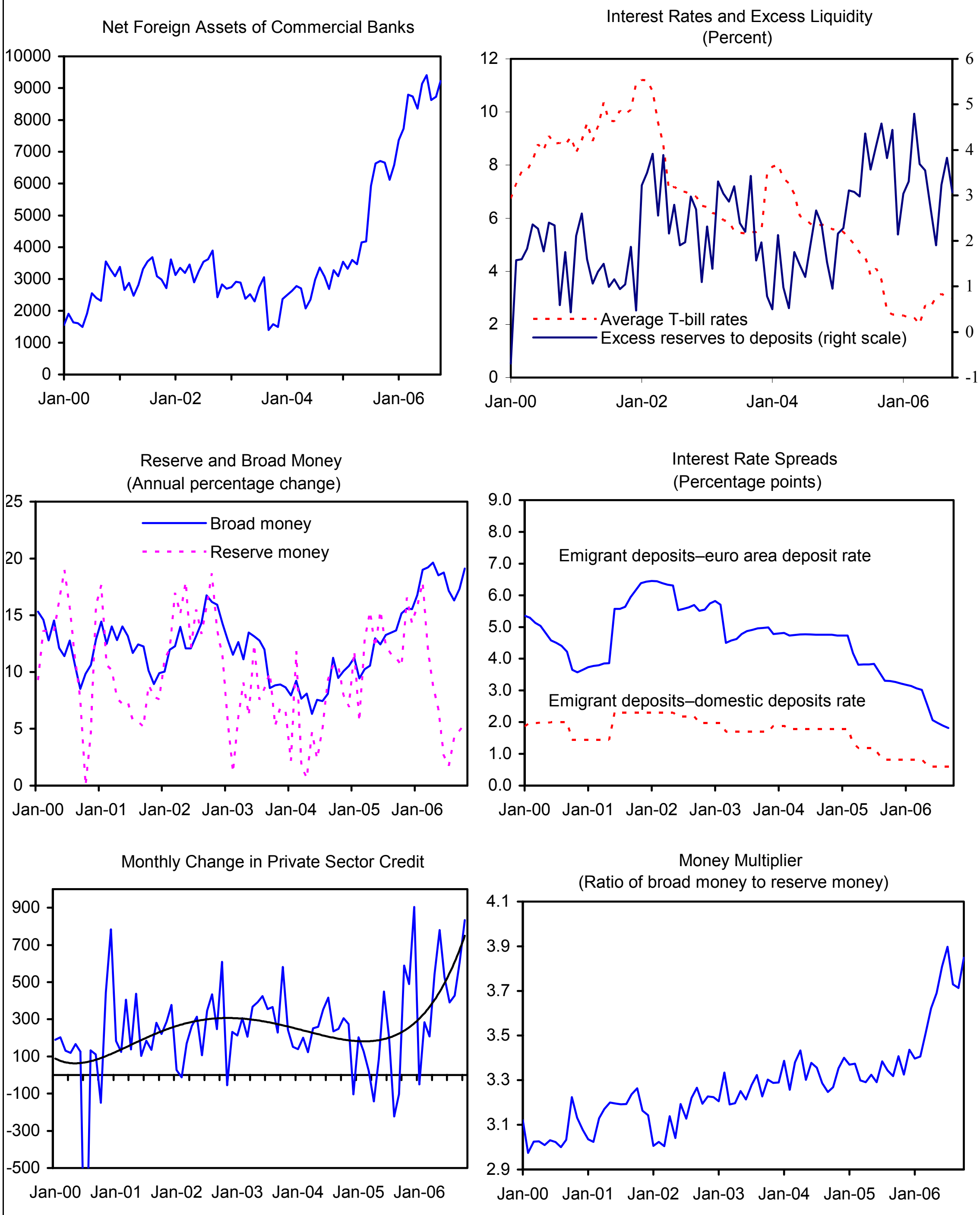


Sources: Cape Verdean authorities, and IMF staff calculations.

[1] Including domestic arrears and excluding government deposits.

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

(Millions of escudos, unless otherwise specified)



Sources: Bank of Cape Verde, and IMF staff calculations.

6. **Fiscal performance has been largely consistent with the objectives set out at the start of the PSI program**. In particular, the quantitative assessment criterion on net domestic borrowing of the central government was satisfied in the first three quarters of 2006. Recurrent spending, including wages and pensions, is unfolding more slowly than expected, partly because of the constraints on hiring and promotions introduced earlier in 2006. Capital spending—as in the past—is below budget despite recent improvements in the capacity to implement public investment projects and efforts to reduce lags in donor reporting. Revenues have been more robust than projected, supported by significant growth in customs collections (including value-added taxes)—mainly reflecting strong import growth.

7. **Though the government has been working to clear arrears of central and local government entities, it has not been able to fully prevent accumulation of new arrears.** Some semiautonomous central government entities, such as hospitals, the police, and the army, and some municipalities have persistently failed to pay electricity and water bills on time, breaching the end-September zero program ceiling on accumulation of new arrears. The authorities have requested a waiver for breaching this assessment criterion, on the basis of corrective actions now being taken (see ¶19).

8. **The ownership of Electra (the electricity and water company) changed in September 2006 (see Box 1), leading to a delay in the full implementation of the automatic adjustment mechanism for electricity and water tariffs.** As a result, this end-September structural assessment criterion was missed. The authorities have requested a waiver, based on firm corrective actions now being taken (set out in ¶22).

Box 1. Update on Electra

Frequent interruptions in electricity supply in Praia throughout the first half of 2006 brought to a head the persistent tensions between the Cape Verde government and EDP/AdP, the majority shareholders in Electra. Concerns centered on Electra's lack of investment in electricity and water production, inadequate tariffs, high commercial losses, and poor bill collection rates. With mediation support from the Portuguese government, EDP/AdP and the State of Cape Verde agreed on September 1 to recapitalize Electra and change its ownership structure.

Under the new agreement:

- The government of Cape Verde received 51 percent of the company's shares; municipalities continue to hold 15 percent; and EDP/AdP, which had owned 51 percent, hold the remaining 34 percent.
- The CVEsc 600 million in capital that Electra had before it was privatized has been restored through capital contributions from EDP/AdP, both in kind (conversion of loans to and claims on Electra into capital) and in cash.
- Electra's debt of CVEsc 7.8 billion (€70 million) to a Portuguese bank has been rescheduled. It must now repay the debt in equal installments over 20 years without interest (implying a grant element of around 40 percent). The government of Cape Verde is guaranteeing repayment.

9. **Most other structural reforms are progressing in line with the PSI program.** In particular:

- The Ministry of Finance and Public Administration has set up a macroeconomic policy unit (an end-December 2006 benchmark) that will be fully operational by end-March 2007.

- With background work largely completed, legislation to streamline tax incentives and exemptions will soon be drafted (an end-June 2007 benchmark). Related to this, a revised income tax code is also being prepared, with IMF technical assistance. After a consultative process, the draft revised code will be submitted to the National Assembly by end-June 2007 (a new program benchmark—see Table 2 in the MEFP Update).

- The government has set up an interagency unit to ensure that macroeconomic analysis and policy formulation are better coordinated and remain consistent with PSI objectives.

10. **The draft action plan for financial sector development (an end-September 2006 benchmark) is still under preparation** by the BCV-organized task force. A consultant is assessing the legal and institutional framework for the financial sector. Specific recommendations for strengthening and developing this sector will be formulated by the end of 2006 and incorporated into the BCV's 2007 work plan. The BCV intends to implement the proposed reforms by end-June 2007 (a structural benchmark for the PSI program).

11. **Additional fiscal or structural developments include the following:**

- Cape Verde appears to be making satisfactory progress under its compact with the Millennium Challenge Corporation (MCC). The first disbursement on this grant—which is equivalent to 10 percent of GDP, spread over five years—came in late 2005. Cape Verde is eligible to apply for further MCC funding.

- The U. K. government has decided to pay 10 percent of Cape Verde's annual debt service to IDA and the African Development Bank. The resources released, amounting to just over US$0.5 million for 2006, will be spent on poverty reduction.

- As part of its restructuring, the national airline (TACV) has signed an agreement to buy three new planes at a total cost of US$50 million; these will be acquired under a financial lease without government guarantees.

- The government has reached agreement with Cape Verde Telecom to fully liberalize the telecommunications market as of January 2007. This is expected to lower international rates, raise land line charges, and attract additional service providers.

III. Report on the Discussions

12. **In the attached Update to the Memorandum of Economic and Financial Policies (MEFP), the authorities reaffirm their commitment to the policy goals set out in the first MEFP for the PSI program[1]:**

- ***Create fiscal space to meet future pressures on the budget.*** Pressures could arise, for example, from government liabilities to the public pension system; rising demand for health, education, and other public services; and declining access to highly concessional external financing as Cape Verde moves into middle-income status. Key policy objectives are therefore to reduce the government debt ratio, clear arrears, and rationalize tax exemptions.
- ***Support the exchange rate peg*** by increasing foreign reserves and strengthening monetary policy operations.
- ***Strengthen public sector management*** through civil service reforms, better budget and debt management, and improved project appraisal capacities.
- ***Ensure that onshore and offshore financial sector development takes place within an institutional framework that is in line with international best practice***.
- ***Address risks to growth and the fiscal position arising from public service enterprises.*** Central objectives are to improve the regulatory framework for the energy sector and, through this and other reforms, strengthen the commercial operations and investment strategy of Electra.

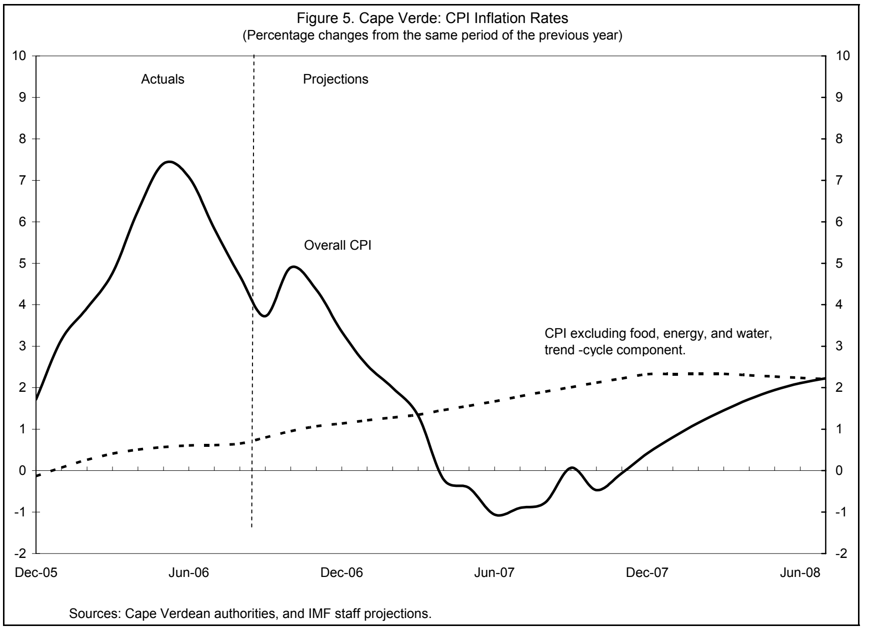
A. Near-Term Outlook and Macroeconomic Framework for 2007

13. **The near- and medium-term growth outlook has improved.** The authorities argued—and the staff agreed—that on balance 2006 GDP growth appears to be stronger than previously projected—possibly around 5.8 percent (up from 5.5 percent). Similarly, the growth projection for 2007 has been revised from 6.0 percent up to 6.5 percent, reflecting in part stronger agricultural prospects resulting from abundant rainfall during 2006 and the carry-over effect from the strong FDI in 2006. Growth is expected to average 6–7 percent over the medium term, driven primarily by the FDI-led expansion of the tourism industry.

14. **Headline inflation is expected to continue its rapid fall as food prices return to more normal levels, as in past episodes of temporary fluctuations in food supplies**. The 12-month inflation rate is projected to decline to 3.3 percent in December 2006 and 0.4 percent in December 2007, stabilizing at around 2–3 percent thereafter (Figure 5).[2] [3]

[1] See Country Report No. 06/334.

[2] On an annual average basis, inflation would be 4.9 percent in December 2006 and 0.2 percent in December 2007.



15. **The fiscal stance appears on track to meet the December 2006 target for net domestic borrowing**. Total revenues are projected to be significantly above and expenditures somewhat below budget. This outcome, together with the upward revision of GDP growth, would allow the net domestic debt-to-GDP-ratio to be reduced faster than expected. Domestic debt is now projected to fall from 33.5 percent of GDP at the end of 2005 to 26.9 percent by the end of 2006 (the initial projection was 28.4 percent).

16. **The BCV's accumulation of international reserves is expected to continue.** The discussions focused on the saving behavior of recipients of large official and private sector foreign exchange inflows, and the possibility that these inflows—which have fueled broad money growth—could, when spent, result in a surge in imports and a loss of reserves. Based on their recent experiences in this area, however, the authorities were reasonably confident that the reserve build-up would be maintained. Correspondingly, the BCV's international reserves are projected to reach 3.4 months of prospective imports by end-December 2006, significantly above the initial program target of 3.1 months. Reserve cover indicators are shown in the table below, including reserves relative to base money and the impact if commercial banks were to place all their excess liquidity abroad.

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[3] These projections are based on the current CPI. The National Statistical Institute (INE) is scheduled to release a new CPI in early 2007 that may be less susceptible to large swings in a few food items.

Cape Verde: Main International Reserve Coverage Indicators

	Dec-00	Dec-04	Dec-05	Sep-06	Dec-06	Dec-07
Gross reserve coverage in months of prospective imports	0.9	2.4	2.8	3.2	3.4	3.5
Less excess liquidity	0.9	2.3	2.5	2.6	3.1	3.4
Including the Portuguese credit line	2.3	3.4	3.6	3.8	4.1	4.1
Gross international reserves to currency in circulation	0.5	1.7	2.1	3.0	2.7	2.8
Gross international reserves to reserve money	0.2	0.6	0.8	1.0	1.0	1.1
Including the Portuguese credit line	0.61	0.88	1.00	1.18	1.24	1.32
Gross international reserves to domestic broad money	0.1	0.3	0.4	0.4	0.4	0.5
Gross international reserves to emigrant and foreign currency deposits	0.2	0.4	0.5	0.6	0.7	0.7
Gross international reserves in millions of euros	30.4	102.4	147.5	189.6	211.0	242.7

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

17. **Against this background, the staff and authorities agreed that the macroeconomic policies for 2007 set forth in the original MEFP are still appropriate.** In particular, macroeconomic policies will continue to be anchored on the goals of increasing reserves and reducing government domestic debt. The original target of increasing reserve coverage by a further 0.1 months of prospective imports in 2007 (about ½ percent of GDP) was retained, but now applies to a higher base than before. Although modest compared with the exceptional reserve buildup in 2006, the authorities felt—and the staff agreed—that the 0.1 month target remained appropriate given the progress already made in building reserves and the possibility of a delayed surge in imports.

18. **The budget for 2007 reinforces the government's commitment to fiscal discipline and to the PSI program objectives.** Recurrent spending is budgeted to decline as a share of GDP, driven by a cautious wage and salary policy and elimination of oil subsidies in mid-2006. This restraint will enable spending on public investment and other high priority areas to be maintained without putting at risk the program's overall fiscal objectives. Reflecting these developments, government net domestic borrowing (other than for clearing arrears) will be limited to –1.5 percent of GDP in 2007, bringing net domestic debt down to about 21.3 percent of GDP at the end of 2007. Hence, the goal of a domestic debt ratio of 20 percent of GDP by 2009 may well be reached ahead of schedule.

B. Structural Fiscal Issues

19. **In the MEFP Update, the government commits to strengthening fiscal policy formulation, implementation, and control.** In addition to measures noted above (¶ 9), the government will

- Implement the medium-term expenditure framework (an end-June 2007 benchmark);
- Implement laws to strengthen the Court of Auditors and the National Chart of Public Accounts (end-June 2007 benchmarks);

- Extend the online system (SIGOF) for budget execution and monitoring across the general government sector, including to municipalities and semiautonomous public entities, with full implementation scheduled for 2008.

- Strengthen its accounting capacity to ensure that execution of the budget is appropriately reflected in the public accounts, data on stocks and flows are reconciled, and errors and omissions in the accounts are reduced;

- Continue to improve its procedures and capacities for managing external and domestic debt; and

- Move decisively to end accumulation of public sector payment arrears. If this problem persists, the authorities intend to make the required payments (e.g., for electricity and water) on behalf of the semiautonomous services concerned and deduct the corresponding amounts from government transfers to these entities. The government is also prepared to propose legislative changes to enable it to follow the same approach for municipality arrears.

C. Monetary Operations

20. **The BCV continues to examine options to improve its framework for monetary operations and liquidity management.** Until recently, the BCV had been fairly passive in using the limited set of monetary policy instruments at its disposal to control liquidity. However, periodic upsurges of excess liquidity and the sharp decline in treasury bill rates in recent years have made it clear the bank needs to take a more active approach. Moreover, increased private sector access to international capital markets and recent borrowing from the offshore financial institutions have accentuated the interest rate pressures and market distortions caused by the high reserve requirement ratio. Staff agreed that it was desirable to reduce the reserve requirement further within the limits given by the overall liquidity situation and the BCV’s own financial position.

21. **The BCV argued, and the staff agreed, that closer monitoring and targeting of external interest rate differentials could provide an effective tool for guiding liquidity management.** The BCV thought that this approach was likely to work better than indicative targets based on monetary aggregates, given the relatively weak and indirect links between these aggregates and Cape Verde’s monetary anchor, the exchange rate peg. With a sizable share of emigrant deposits coming from the United States, differentials with U.S. interest rates are important. Nevertheless, the more closely observed differentials are those with the euro area—especially given the peg to the euro, the importance of the euro area for the operations of commercial banks (including their holdings of foreign assets), and the fact that the majority of emigrant deposits come from euro area countries. In this regard, commercial banks agreed with the authorities that the current interest differential on emigrant deposits against euro area rates of about 200 basis points seems sufficient to prevent an outflow of these deposits, which comprise around 42 percent of bank deposit liabilities. However, there is still considerable downward pressure on emigrant deposit rates, which are currently 140 basis points above treasury bill rates. The BCV therefore felt there was a need for further open market operations to increase treasury bill rates somewhat and reduce excess liquidity.

D. Energy and Water Sector Issues

22. **Re-acquiring majority control of Electra has put the authorities in a position to take much-needed steps to improve the company's operating performance and push its investment program forward.**[4] The government has given Electra's new management team a clear mandate to run the company on fully commercial terms and is now moving forcefully to support the strengthening of Electra' operations. In particular, the government recognizes the urgency of putting in place the long-overdue automatic adjustment mechanism for electricity and water tariffs. While the reduction in international oil prices since June 2006 (when electricity and water tariffs were last adjusted) has helped mitigate the immediate effects of the delayed implementation of this mechanism on Electra's financial position and on fiscal risks, the authorities agreed that they could not count on favorable trends in international oil prices in future. An action plan for finalizing the mechanism has been signed by Electra, the economic regulatory agency (ARE), and the government, under which the mechanism was approved on November 30, 2006 and is to be fully implemented in the first quarter of 2007. In addition, public sector arrears to Electra are being cleared and the government is committed (see ¶19) to taking strong measures to end accumulation of new public sector payment arrears. The government is also assessing whether regulatory reforms are needed to reinforce Electra's ability to bill clients.

23. **Supported by these reforms, Electra is now moving ahead with investments to build efficiency and capacity in domestic electricity and water production and reduce its dependence on imported fuel.** The immediate priorities in its medium-term investment plan are new electricity generators and water desalinization plants for the capital, Praia, and interconnection lines so that the increase in electricity generation capacity can be transmitted to other communities on Santiago Island. The total cost of these three projects is about \$25 million over 2007–08. These investments are not only critical for growth, they also have high rates of return; estimated payback periods are only two to three years in some cases. The government is currently seeking concessional assistance from multilateral banks, including the African Development Bank, and donors to finance Electra's investment program. However, to avoid delay on the most urgent investments, the government is prepared to allow Electra to either fund them domestically (through its own resources or domestic loans) or to seek external loans on commercial terms with government guarantees (see ¶ 27 below).

24. **The mechanism for adjusting retail fuel prices in response to changes in import prices has not been working as originally envisaged.** With the last adjustment in fuel prices having occurred in April 2006, domestic prices have not reflected the subsequent movements up and down in international oil prices. The authorities fully agreed with the staff that improvements are needed in the transparency and automatic implementation of price adjustments. Correspondingly, the government has formed an interagency task force to review the mechanism. Reforms based on the task force's recommendations will be implemented by end-June 2007.

[4] See previous staff reports and Box 1 of this staff report for summaries of the long-standing difficulties between the government of Cape Verde and the previous private majority shareholders of Electra.

E. Financing Flexibility, Debt Management, and Project Appraisal

25. **As highly concessional financing is likely to become increasingly difficult to secure after Cape Verde graduates from LDC status, other financing options need to be developed**. In support of its development strategy, the government has recently presented an ambitious plan for infrastructure investment to the international community, including multilateral banks and donors. While continuing to seek concessional assistance for this plan to the extent possible, the government has also been exploring other financing possibilities—including public-private partnerships and greater use of government guarantees. A resource mobilization unit is being set up in the Ministry of Finance to support these efforts.

26. **Staff emphasized the following measures to ensure that increased financing flexibility does not create fiscal risks or jeopardize Cape Verde's long-term debt sustainability[5]:**

- Strengthen capacity to assess proposed public investment projects, including their financing structure and their implications for debt sustainability and other fiscal risks;
- Improve recording and management of government and government-guaranteed debt;
- Operate public enterprises on fully commercial terms; and
- Insist on sound procedures within public enterprises for recording debt and debt service obligations, whether or not covered by government guarantees.

27. **Discussions also addressed use of the current program ceiling on nonconcessional government and government-guaranteed external borrowing, and a possible increase in this ceiling.** The 2007 budget identifies priority projects of the national airport operator ASA and the port operator ENAPOR that could be supported through government-guaranteed loans within the current program ceiling of $20 million. The authorities noted that the program of airport and port development is critical for tourism development and economic diversification, and that these companies operate on a commercial basis without budget support.[6] In addition, with Electra recently coming under public ownership and hence within the scope of the nonconcessional borrowing ceiling, the government is requesting an increase in the 2007 ceiling from US$20 million to US$35 million in case Electra needs government-guaranteed external loans to implement its priority projects (see ¶ 23) without delay. In discussing this request, staff emphasized the

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[5] See the Debt Sustainability Analysis (DSA) in the previous staff report (Country Report No. 06/334): the DSA of external debt indicated that Cape Verde's NPV of debt-to-exports ratio would decrease from 91 to 83 percent in the baseline scenario, while the debt service to exports ratio would rise gradually from 7 percent to 11 percent by 2026—both well below the policy-dependent thresholds.

[6] ASA has received government guarantees in the past to lower its financing costs and may receive additional support by end-2006 within the current ceiling of $20 million. This company has fully met its debt service obligations.

importance of the measures noted above to strengthen Electra's commercial operations, along with the other reforms—relevant for public sector investment as a whole—to improve debt management practices and project appraisal capacities.

IV. Program Monitoring

28. **Proposed assessment criteria, benchmarks, and indicative targets for the next three reviews are specified in Tables 1 and 2 of the authorities' MEFP Update** (Appendix I, Attachment I). The second review is scheduled to be completed by end-April 2007.[7]

V. Staff Appraisal

29. **Cape Verde's economic and policy performance has been strong.** Already solid growth is being reinforced by increases in tourism and FDI, and inflation is falling faster than expected. Fiscal and monetary policies are on track to substantially surpass key program objectives—notably the reduction in domestic debt as a share of GDP and the build-up of official foreign exchange reserves. The government's program for 2007 is well aligned with the policy strategy agreed upon at the outset of the PSI program.

30. **The budget for 2007 demonstrates the government's commitment to fiscal discipline.** Because government domestic borrowing is set to be lower than initially targeted, additional fiscal space is being created to help manage potential pressures on spending and access to concessional external financing. As a result, the 2007 budget will support Cape Verde's preparations for meeting the opportunities and challenges associated with its transition from UN LDC status in 2008.

31. **The authorities must move rapidly to ensure that financial sector development, especially in the offshore center, takes place under institutional conditions consistent with international best practice.** Their efforts, which should also cover provisions for anti-money laundering and combating the financing of terrorism (AML/CFT), should draw on the current consultancy contract and on other recent assessments of risks and vulnerabilities.

32. **While it is unfortunate that two end-September 2006 assessment criteria were not met, the staff commends the authorities for taking clear corrective measures.** Based on their actions, and on the demonstrated strength of their commitment to PSI objectives, the staff supports the request of the authorities for waivers.

33. **Ending the persistent problem of arrears accumulation is essential for sound public finance management and ensuring the credibility of government as a diligent economic agent.** Staff recognizes the constraints that prevented more timely resolution of the arrears, especially given the autonomous or semiautonomous status of many of the entities

[7] The relatively short interval between the first and second reviews is the result of the program adjustment from the end-September 2006 test date at the outset of the program, to the regular cycle of end-December and end-June test dates for the rest of the program.

involved. From this perspective, the authorities' commitment to addressing the arrears problem directly is all the more commendable.

34. **Ensuring a stable and cost-effective supply of electricity and water is crucial if Cape Verde is to realize its growth potential and poverty reduction goals. Staff therefore urges full and rapid implementation of the measures discussed in the MEFP to strengthen the regulatory environment for the energy sector and hence support Electra's operating performance.** Recognizing that Electra's investment program needs to be implemented without delay, staff also supports the government's request to raise the 2007 ceiling on nonconcessional government and government-guaranteed external borrowing from US$20 million to US$35 million. Staff notes that, even with this increase, Cape Verde would remain well within debt distress thresholds.

35. **Based on the overall strength of the authorities' policies, the staff supports completion of the program review.**

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

	2002	2003	2004	2005	2006		2007	2008	2009
					Program	Rev. Proj.	Projections		
					(Annual percentage change)				
National accounts and prices									
Real GDP	5.3	4.7	4.4	5.8	5.5	5.8	6.5	7.0	7.2
Real GDP per capita	3.4	2.8	2.5	3.8	3.5	3.8	4.6	5.0	5.2
Consumer price index (annual average)	1.9	1.2	-1.9	0.4	6.2	4.9	0.2	1.9	2.5
Consumer price index (end of period)	3.0	-2.3	-0.3	1.7	5.5	3.3	0.4	2.4	2.6
External sector									
Exports of goods and services	14.1	6.1	5.2	24.3	8.9	32.8	13.8	13.0	11.9
Imports of goods and services	15.3	7.5	6.5	0.5	14.6	23.7	16.1	11.7	13.0
Real effective exchange rate (annual average)	0.5	1.8	-3.0	-2.3	...	...	...	...	...
Terms of trade (minus = deterioration)	-0.7	1.9	-2.2	-2.3	-0.5	-3.9	0.7	1.9	1.8
Government budget									
Total revenue (excluding grants)	12.3	5.1	8.4	11.3	17.3	30.7	-2.3	11.6	13.7
Total expenditure	13.4	-1.4	19.2	10.0	27.8	12.1	10.0	4.8	9.8
Noncapital expenditure	6.2	8.6	20.9	3.5	20.7	11.0	-0.3	11.6	9.0
Capital expenditure	27.8	-18.0	15.3	25.2	40.1	14.1	29.3	-4.9	11.2
Money and credit									
Net foreign assets	18.6	-7.7	31.9	58.8	19.0	41.0	18.8	13.3	12.6
Net domestic assets	13.1	13.2	5.7	3.4	11.2	7.4	7.9	10.4	11.2
Of which: net claims on the central government	22.8	3.4	1.4	0.9	6.9	-8.0	-14.1	-3.0	3.1
credit to the economy	12.0	15.2	9.3	9.2	13.7	16.3	15.7	14.1	13.1
Broad money (M2)	14.3	8.6	10.5	15.5	13.6	17.5	11.8	11.6	11.8
Domestic broad money (M2X)	10.2	4.2	8.8	17.3	15.4	19.4	11.8	11.6	11.8
Income velocity (GDP/M2)	1.48	1.46	1.37	1.31	1.27	1.27	1.21	1.19	1.18
					(Percent of GDP)				
Saving-investment balance									
Gross capital formation	35.8	31.0	37.4	37.3	38.7	39.4	42.9	46.6	49.8
Government	9.2	6.4	7.7	9.0	14.4	9.0	10.7	10.0	10.2
Nongovernment	26.7	24.7	29.7	28.4	24.2	30.3	32.2	36.6	39.6
Gross national savings	24.4	20.0	23.1	33.9	31.8	34.7	33.0	34.6	36.6
Of which: government	5.7	5.3	5.9	6.3	9.0	10.1	8.4	8.0	9.1
External current account (including official current transfers)	-11.4	-11.1	-14.4	-3.4	-6.9	-4.7	-9.9	-12.0	-13.2
Government budget									
Total revenue	22.9	22.0	23.1	23.8	25.1	27.4	24.6	25.1	25.8
Total grants	8.7	5.5	9.0	6.4	9.0	7.0	7.6	7.0	7.0
Total expenditure	34.4	31.1	35.9	36.6	41.2	36.1	36.5	34.9	34.6
Overall balance before grants	-11.5	-9.1	-12.7	-12.7	-16.1	-8.7	-11.9	-9.8	-8.9
Overall balance (including grants)	-2.9	-3.5	-3.8	-6.3	-7.1	-1.7	-4.2	-2.9	-1.8
External financing (net)	-1.3	1.8	0.4	3.1	3.5	2.6	2.8	2.2	1.4
Domestic financing (net)	6.4	2.0	1.1	0.8	3.6	0.3	1.5	0.7	0.5
Financing gap/ statistical discrepancy	-2.2	-0.3	2.3	2.4	0.0	-1.3	0.0	0.0	0.0
Total nominal government debt[1]	86.7	86.7	88.3	86.6	80.8	73.2	68.3	63.9	58.3
External government debt[2]	57.5	57.5	54.0	53.2	52.4	46.3	45.0	43.1	40.1
Domestic government debt, net of deposits[3]	29.2	29.2	34.3	33.5	28.4 [4]	26.9	23.2	20.8	18.2
External current account (excluding official current transfers)	-17.2	-17.1	-20.1	-8.0	-14.4	-9.7	-14.9	-16.0	-17.1
Overall balance of payments	6.3	-0.7	4.1	5.6	2.2	7.1	3.1	3.6	3.8
External current account (millions of euros, including official transfers)	-75.5	-79.7	-107.0	-27.3	-61.0	-42.7	-98.4	-130.8	-159.5
Gross international reserves (millions of euros, end of period)	76.1	74.1	102.4	147.4	166.4	211.0	242.6	282.0	328.7
Gross international reserves (months of prospective imports of goods and services)	1.9	1.7	2.4	2.8	3.1	3.4	3.5	3.6	3.7
External debt service (percent of exports of goods and services)	12.4	10.5	11.3	8.6	8.2	5.3	5.4	6.2	6.5
Memorandum items:									
Nominal GDP (billions of Cape Verde escudos)	72.8	79.5	82.1	88.6	98.1	100.6	109.4	119.9	132.8
PV of external debt in percent of GDP	0.0	0.0	0.0	32.1	30.7	29.1	29.2	28.5	26.8
GDP per capita (U.S. dollars)	1,378	1,774	1,979	2,100	…				
Exchange rate (Cape Verde escudos per U.S. dollar)									
Period average	117.2	97.7	88.8	88.7	…	…	…	…	…
End period	105.1	87.3	81.0	93.5	…	…	…	…	…

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

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

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

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

[4] The 2005 domestic debt stock has been revised up by 1,160 million escudos compared with the data reported in CR/06/334; to ensure comparability, 2006 program projections have been revised up by the same amount.

Table 2. Cape Verde: Annual Fiscal Operations of the Central Government, 2005–07

(Millions of Cape Verde escudos, unless otherwise indicated)

	2005	2006				2007	2008	2009
	Prel.	Program	Jan.-June prel.	Jan.-Sept prel.	Rev. Proj.	Budget	Proj.	Proj.
Revenue, grants, and net lending	26,779	33,437	13,921	21,884	34,603	35,295	38,441	43,546
Domestic revenue (incl. net lending)	21,123	24,604	11,907	17,583	27,600	26,963	30,083	34,214
Tax revenue	18,601	21,099	10,607	15,910	23,550	24,178	26,670	30,416
Income and profit taxes	5,822	6,955	3,466	4,924	7,600	7,497	8,363	9,514
Consumption taxes	7,390	8,351	4,393	6,705	9,900	10,140	11,311	12,869
International trade taxes	4,231	4,501	2,233	3,464	4,650	5,458	5,788	6,800
Other taxes	1,158	1,291	515	817	1,400	1,083	1,208	1,233
Nontax revenue	2,375	3,505	1,088	1,438	3,800	2,585	3,263	3,698
Net lending	147	0	192	234	250	200	150	100
External grants	5,657	8,833	2,015	4,301	7,003	8,332	8,358	9,332
Capital grants	5,106	7,003	1,463	3,098	5,369	6,706	7,641	8,596
Of which: MCI	665	333	...	...	316	1,287	1,854	2,276
Budget support	551	1,830	551	1,204	1,634	1,625	717	736
Total expenditure	32,395	40,413	14,535	23,150	36,309	39,943	41,878	45,993
Recurrent expenditure	18,948	22,416	8,488	12,395	21,671	22,575	24,289	26,242
Primary recurrent expenditure	17,018	20,593	7,529	10,975	19,868	20,692	22,185	24,009
Wages and salaries	10,733	12,712	5,192	7,532	12,420	13,165	13,955	14,875
Goods and services	1,157	1,862	509	616	1,862	2,127	2,341	2,616
Transfers and subsidies	3,149	5,146	1,231	2,183	4,713	3,869	4,220	4,671
Transfers	2,616	3,921	1,190	2,207	3,780	3,834	4,181	4,628
Of which: student scholarships	282		169	230	500	500	500	500
Subsidies	533	1,225	42	-24	933	35	39	43
Of which: petrol price subsidies	450	1,200	0	0	908	0	0	0
Other expenditures	1,979	873	597	644	873	1,531	1,669	1,847
Domestic interest payments	1,384	1,300	693	1,022	1,300	1,352	1,352	1,381
External interest payments	546	522	265	398	504	531	751	852
Extraordinary expenditures	0		0	0	0	0	0	0
Capital expenditure	11,073	16,290	4,821	7,762	12,638	16,340	15,546	17,287
Foreign financed	9,204	12,534	3,877	6,294	9,258	13,487	12,107	13,040
Domestically financed	1,869	3,755	944	1,468	3,380	2,853	3,439	4,248
Other expenditures (incl. arrears clearance)	2,374	1,708	1,483	2,992	2,000	1,028	2,043	2,464
Overall balance, including grants	-5,615	-6,976	-614	-1,266	-1,706	-4,648	-3,437	-2,448
Financing	5,615	6,976	614	1,266	1,706	4,648	3,437	2,448
Foreign (net)	2,785	3,414	363	2,544	2,663	3,042	2,662	1,878
Domestic financing (net)	713	3,575	-989	-14	307	1,605	800	600
Net domestic borrowing	713	830	-325	443	318	-602	800	600
Banking system	141	989	-224	-741	-1,219	-1,976	-357	364
Nonbanks	572	-158	-101	1,184	1,537	1,374	1,157	236
Privatization and other sales of assets	816	3,689	279	487	933	2,207	0	0
Other	-12	-944	-944	-944	-944	0	0	0
Net errors and omissions	2,118	0	1,240	-1,264	-1,264	0	0	0
Memorandum items:								
Overall balance, including grants (excluding clearance of arrears and net late payments)	-4,174	-4,324	588	581	1,238	-3,620	-2,124	-1,134
Clearance of accounts payable (late payments or *atrasados*)	12	944	944	944	944	0	0	0
Arrears clearance (part of *despesa extraordinaria* and other)	1,430	1,708	257	903	2,000	1,028	1,313	1,313
Domestic borrowing excluding for clearance of arrears and net late payments	-728	-1,821	-1.526	-1.404	-2,626	-1,630	-513	-713
Primary balance (including grants)[1]	-11,272	-5,154	345	154	-8,709	-12,979	-11,795	-11,780
Recurrent domestic balance[2]	2,175	2,188	3,419	5,188	5,929	4,389	5,794	7,972
Net external flows[3]	8,441	12,234	2,377	6,845	9,665	11,374	10,995	11,180
External debt service (in percent of domestic revenue)	12,250	10,729	...	...	9,496	9,803	11,526	11,858
Domestic debt (including arrears and accounts payable, net of deposits)	29,681	27,860 [4]	...	...	27,056	25,426	24,913	24,199

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

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

[2] Domestic revenue – recurrent expenditure.

[3] External grants + net foreign financing.

[4] The 2005 domestic debt stock has been revised up by 1,160 million escudos compared with the data reported in CR/06/334; to ensure comparability, 2006 program projections have been revised up by the same amount.

Table 3. Cape Verde : Annual Fiscal Operations of the Central Government , 2005–07

(Percent of GDP)

	2005	2006				2007
	Prel.	Program	Jan.-June prel.	Jan.-Sept prel.	Rev. Proj.	Budget
Revenue, grants, and net lending	30.2	34.1	13.8	21.8	34.4	32.3
Domestic revenue (incl. net lending)	23.8	25.1	11.8	17.5	27.4	24.6
Tax revenue	21.0	21.5	10.5	15.8	23.4	22.1
Income and profit taxes	6.6	7.1	3.4	4.9	7.6	6.9
Consumption taxes	8.3	8.5	4.4	6.7	9.8	9.3
Taxes on goods and services	0.9	1.0	0.7	1.0	1.6	1.4
Value-added tax	7.4	7.5	3.7	5.7	8.3	7.9
International trade taxes	4.8	4.6	2.2	3.4	4.6	5.0
Other taxes	1.3	1.3	0.5	0.8	1.4	1.0
Nontax revenue	2.7	3.6	1.1	1.4	3.8	2.4
Profit transfers	0.0	0.6	0.1	0.2	0.6	0.3
Domestic capital participation	0.2	0.3	0.0	0.0	0.3	0.0
External grants	6.4	9.0	2.0	4.3	7.0	7.6
Capital grants	5.8	7.1	1.5	3.1	5.3	6.1
Of which: MCI	0.8	0.3	...	...	0.3	1.2
Budget support	0.6	1.9	0.5	1.2	1.6	1.5
Total expenditure	36.6	41.2	14.5	23.0	36.1	36.5
Recurrent expenditure	21.4	22.8	8.4	12.3	21.6	20.6
Primary recurrent expenditure	19.2	21.0	7.5	10.9	19.8	18.9
Wages and salaries	12.1	13.0	5.2	7.5	12.4	12.0
Goods and services	1.3	1.9	0.5	0.6	1.9	1.9
Transfers and subsidies	3.6	5.2	1.2	2.2	4.7	3.5
Other expenditures	2.2	0.9	0.6	0.6	0.9	1.4
Domestic interest payments	1.6	1.3	0.7	1.0	1.3	1.2
External interest payments	0.6	0.5	0.3	0.4	0.5	0.5
Extraordinary expenditures	0.0	0.0	0.0	0.0	0.0	0.0
Capital expenditure	12.5	16.6	4.8	7.7	12.6	14.9
Foreign financed	10.4	12.8	3.9	6.3	9.2	12.3
Domestically financed	2.1	3.8	0.9	1.5	3.4	2.6
Other expenditures (incl. arrears clearance)	2.7	1.7	3.0	2.0	2.0	0.9
Overall balance, including grants	-6.3	-7.1	-0.6	-1.3	-1.7	-4.2
Financing	6.3	7.1	0.6	1.3	1.7	4.2
Foreign (net)	3.1	3.5	0.4	2.5	2.6	2.8
Total drawings	5.4	5.6	1.4	3.9	4.8	4.7
Amortization	-2.3	-2.2	-1.0	-1.4	-2.1	-1.9
Domestic financing (net)	0.8	3.6	-1.0	0.0	0.3	1.5
Net domestic borrowing	0.8	0.8	-0.3	0.4	0.3	-0.5
Banking system	0.2		-0.2	-0.7	-1.2	-1.8
Nonbanks	0.6		-0.1	1.2	1.5	1.3
Privatization and other sales of assets	0.9	1.4	0.3	0.5	0.9	2.0
Other	0.0	2.3	-0.9	-0.9	-0.9	0.0
Net errors and omissions	2.4	0.0	1.2	-1.3	-1.3	0.0
Financing gap	0.0	0.0	...	...	...	0.0
Memorandum items:						
Overall balance, including grants (excluding clearance of arrears and net late payments)	-4.7	-4.4	0.6	1.2	1.2	-3.3
Clearance of accounts payable (late payments or *atrasados*)	0.0	1.0	0.9	0.9	0.9	0.0
Arrears clearance (part of *despesa extraordinaria* and other)	1.6	1.7	0.9	2.0	2.0	0.9
Domestic borrowing excluding for clearance of arrears and net late payments	-0.8	-1.9	-1.4	-2.6	-2.6	-1.5
Primary balance (including grants) [1]	-4.2	-5.3	0.3	0.2	0.1	-2.5
Recurrent domestic balance [2]	2.5	2.2	3.4	5.2	5.9	4.0
Net external flows [3]	9.5	12.5	2.4	6.8	9.6	10.4
External debt service (percent of domestic revenue)	13.8		0.0	0.0	9.4	9.0
Domestic debt (including arrears and accounts payable, net of deposits)	33.5	28.4 [4]	...	...	26.9	23.2

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

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

[2] Domestic revenue – recurrent expenditure .

[3] External grants + net foreign financing.

[4] The 2005 domestic debt stock has been revised up by 1,160 million escudos compared with the data reported in CR/06/334; to ensure comparability, 2006 program projections have been revised up by the same amount.

Table 4. Cape Verde: Balance of Payments, 2005–09
(Millions of Cape Verde escudos, unless otherwise indicated)

	2005	2006		2007	2008	2009
		Program	Rev. Proj.	Projections		
Current account balance (including official transfers)	-3,016	-6,725	-4,705	-10,849	-14,425	-17,589
Trade balance	-30,960	-37,178	-38,554	-42,746	-51,340	-60,252
Exports, f.o.b.	7,891	8,862	8,742	9,263	9,582	9,849
Imports, f.o.b.	-38,851	-46,040	-47,295	-52,009	-60,922	-70,101
Services (net)	6,148	5,782	10,858	9,597	14,964	18,524
Credit	24,667	25,513	34,508	39,975	46,080	52,431
Of which: tourism	10,466	10,327	17,819	22,097	25,812	29,677
Debit	-18,519	-19,731	-23,650	-30,378	-31,117	-33,907
Income (net)	-2,984	-2,905	-3,952	-3,963	-4,364	-4,420
Credit	1,641	2,167	2,397	3,011	3,392	3,769
Debit	-4,625	-5,073	-6,349	-6,973	-7,756	-8,189
Government interest	-551	-713	-504	-531	-751	-852
Interest by other sectors	-3,040	-3,587	-3,802	-4,390	-4,658	-4,929
Income on direct investment and other income	-1,034	-773	-2,043	-2,053	-2,347	-2,408
Current transfers (net)	24,780	27,577	26,942	26,263	26,315	28,559
Government	4,090	7,404	5,023	5,492	4,777	5,143
Other	20,690	20,173	21,920	20,771	21,538	23,416
Capital and financial account (net)	7,859	8,900	11,823	14,254	18,701	22,681
Capital transfers	1,821	1,420	1,764	2,863	3,581	4,189
Government	1,831	1,420	1,764	2,863	3,581	4,189
Of which: MCA	665	333	316	1,287	1,854	2,276
Other	200	0	0	0	0	0
Direct investment (net)	6,696	2,110	8,779	10,095	11,431	12,729
Portfolio investment	0	0	0	0	0	0
Government	1,880	3,431	3,006	3,029	2,662	1,878
Trust Fund	-200	0	0	0	0	0
Net official flows	2,080	3,431	3,006	3,029	2,662	1,878
Disbursements	4,314	5,531	4,780	5,155	5,378	5,083
Amortization	-2,234	-2,101	-1,774	-2,127	-2,716	-3,205
Other	0	0	0	0	0	0
Other capital	-2,538	1,939	-1,726	-1,733	1,027	3,885
Commercial banks	-4,055	-2,071	-1,914	-2,288	-481	29
Commercial credit (net)	564	0	0	0	0	0
Other	953	4,011	188	555	1,508	3,856
Net errors and omissions	158	0	0	0	0	0
Overall balance	5,000	2,175	7,118	3,405	4,276	5,092
Financing	-5,000	-2,096	-7,008	-3,492	-4,347	-5,151
Gross international reserves (– accumulation)	-4,964	-2,096	-7,008	-3,492	-4,347	-5,151
Of which: IMF (net)	380	0	-43	-18	-65	-127
Exceptional financing	-36	0	0	0	0	0
Financing gap	0	-80	111	-88	-71	-59
Memorandum items:						
Current account (including official transfers)	-3.4	-6.9	-4.7	-9.9	-12.0	-13.2
Current account (excluding official transfers)	-8.0	-14.4	-9.7	-14.9	-16.0	-17.1
Overall balance	5.6	2.2	7.1	3.1	3.6	3.8
Gross international reserves	16,260	18,356	23,268	26,760	31,107	36,258
Months of current year's import of goods and services	3.4	3.3	3.9	3.9	4.1	4.2
Months of next year's import of goods and services	2.8	3.1	3.4	3.5	3.6	3.7
External public debt	47,099	51,456	46,491	49,520	51,678	53,333
Including financing gap	47,099		46,602	49,543	51,631	53,227
External aid (grants and loans; percent of GDP)	11.6	14.6	11.5	12.3	11.5	10.9

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

Table 5. Cape Verde: Monetary Survey, 2005–09

	2005	2006		2007	2008	2009
	Dec.	Dec.		Dec.		
		Program	Rev. Proj.	Projections		
	(Millions of Cape Verde escudos, unless otherwise specified)					
Net foreign assets	21,889	26,056	30,854	36,653	41,546	46,795
Foreign assets	27,549	31,716	37,175	43,110	48,044	53,275
Of which: foreign reserves	16,260	18,356	23,268	26,760	31,107	36,258
Foreign liabilities	-5,660	-5,660	-6,321	-6,458	-6,499	-6,480
Net domestic assets	50,755	56,456	54,493	58,772	64,902	72,184
Net domestic credit	60,193	65,127	64,372	68,694	74,869	82,197
Net claims on general government	25,652	25,854	24,209	22,233	21,876	22,240
Claims on the Trust Fund (TCMFs)	11,038	11,038	11,038	11,038	11,038	11,038
Net claims on the central government	15,207	15,406	13,988	12,012	11,655	12,018
Credit to central government	20,044	21,033	19,550	17,477	17,027	17,303
Deposits of central government	-4,837	-5,626	-5,562	-5,465	-5,373	-5,285
Of which: project deposits	-351	-277	-421	-277	-277	-277
Net claims on local government	-24	-22	-247	-248	-248	-248
Net claims on other government agencies (INPS)	-569	-569	-569	-569	-569	-569
Credit to the economy	34,541	39,273	40,162	46,461	52,993	59,957
Credit to public enterprises	476	497	511	546	571	597
Credit to private sector	34,040	38,751	39,640	45,904	52,412	59,349
Claims on nonbank financial institutions	26	26	11	11	11	11
Other items (net)	-9,438	-8,671	-9,878	-9,922	-9,967	-10,013
Broad money (M2)	72,644	82,511	85,347	95,424	106,448	118,979
Narrow money (M1)	28,719	32,620	33,741	37,725	42,083	47,038
Currency outside banks	7,634	8,464	8,721	9,477	10,296	11,232
Demand deposits	21,086	24,156	25,020	28,249	31,787	35,806
Quasi money	40,566	46,076	47,660	53,287	59,443	66,441
Time deposits	38,390	43,605	45,103	50,429	56,255	62,877
Other quasimonetary deposits	2,176	2,471	2,556	2,858	3,188	3,564
Foreign currency deposits	3,359	3,815	3,946	4,412	4,922	5,501
	(Change in percent of broad money 12 months earlier)					
Net foreign assets	12.9	5.7	12.3	6.8	5.1	4.9
Net domestic assets	2.7	7.8	5.1	5.0	6.4	6.8
Net domestic credit	4.6	7.9	5.8	5.1	6.5	6.9
Net claims on the central government	0.2	1.4	-1.7	-2.3	-0.4	0.3
Credit to the economy	4.6	6.5	7.7	7.4	6.8	6.5
Credit to public enterprises	0.5	0.0	0.0	0.0	0.0	0.0
Credit to private sector	4.2	6.5	7.7	7.3	6.8	6.5
Other items (net)	-1.9	0.0	-0.6	-0.1	0.0	0.0
Selected monetary indicators:						
Income velocity of money	1.31	1.27	1.27	1.21	1.19	1.18
Emigrant deposits	28,318	31,339	32,416	36,244	40,431	45,190
Excess reserves /total deposits (percent)	2.1	0.8	2.5	1.0	0.9	0.9
Money multilplier (M2/M0)	3.44	3.69	3.74	3.97	4.00	4.03
Credit to the economy (percentage change)	9.2	13.7	16.3	15.7	14.1	13.1

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

Table 6. Cape Verde: Central Bank Survey, 2005–09

	2005	2006		2007	2008	2009
	Dec.	Dec.		Dec.		
		Program	Rev. Proj.	Projections		
	(Millions of Cape Verde escudos, unless otherwise specified)					
Bank of Cape Verde						
Net foreign assets	15,308	17,403	22,359	25,869	30,281	35,559
Of which: net international reserves	15,109	17,204	22,160	25,670	30,082	35,360
Foreign assets	16,523	18,618	23,530	27,023	31,370	36,521
Foreign liabilities	-1,215	-1,215	-1,172	-1,153	-1,089	-961
Net domestic assets	5,828	4,965	463	-1,837	-3,685	-6,053
Net domestic credit	7,678	6,047	2,656	399	-1,403	-3,725
Trust Fund claims	4,605	4,605	4,605	4,605	4,605	4,605
Net claims on central government	1,882	1,093	118	-69	-69	-69
Credit to central government	4,779	4,779	3,739	3,552	3,552	3,552
Deposits of central government	-2,896	-3,685	-3,621	-3,621	-3,621	-3,621
Of which: project accounts	-351	-277	-421	-277	-277	-277
Of which: foreign currency deposits	-1,347	-1,347	-862	-862	-862	-862
Claims on local government	0	0	0	0	0	0
Credit to the economy	1,163	1,163	1,152	1,249	1,362	1,503
Credit to public enterprises	54	54	47	47	47	47
Credit to private sector	1,094	1,094	1,094	1,191	1,304	1,445
Claims on nonbank financial institutions	15	15	11	11	11	11
Credit to commercial banks	27	-815	-3,220	-5,385	-7,301	-9,764
Other items (net)	-1,850	-1,082	-2,193	-2,237	-2,282	-2,327
Assets	2,482	1,442	2,606	2,658	2,711	2,765
Liabilities	4,332	2,525	4,799	4,895	4,993	5,092
Reserve money (M0)	21,136	22,368	22,821	24,032	26,596	29,507
Currency outside banks	7,634	8,464	8,721	9,477	10,296	11,232
Cash in vaults	1,058	1,205	1,138	1,277	1,429	1,601
Deposits of commercial banks	12,443	12,697	12,960	13,277	14,870	16,672
Deposits of private sector	0	0	0	0	0	0
Deposits of other financial institutions	2	2	2	2	2	2
Gross international reserves (millions of euros)	147.4	166.4	211.0	242.6	282.0	328.7
Net international reserves (millions of euros)	137.0	156.0	200.9	232.7	272.7	320.6
Reserve money (12-month change in percent)	14.3	5.8	8.0	5.3	10.7	10.9

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

Table 7. Cape Verde: Deposit Money Bank Survey, 2005–09

	2005	2006		2007	2008	2009
	Dec.	Dec.		Dec.		
		Program	Rev. Proj.	Projections		
	(Millions of Cape Verde escudos, unless otherwise specified)					
Commercial banks						
Net foreign assets	6,581	8,652	8,495	10,783	11,265	11,236
Foreign assets	11,026	13,098	13,645	16,088	16,675	16,754
Foreign liabilities	-4,445	-4,445	-5,150	-5,304	-5,410	-5,518
Of which: Nonresident deposits	-3,520	-3,766	-3,766	-3,879	-3,957	-4,036
Net domestic assets	58,428	65,395	68,131	75,164	84,887	96,512
Net domestic credit	66,016	72,982	75,814	82,848	92,571	104,196
Net claims on general government	19,165	20,156	19,486	17,697	17,340	17,704
Trust Fund claims	6,433	6,433	6,433	6,433	6,433	6,433
Other government deposits (INPS)	-569	-569	-569	-569	-569	-569
Net claims on central government	13,324	14,313	13,870	12,081	11,724	12,087
Treasury bonds	9,173	9,847	9,317	7,137	6,316	6,101
Treasury bills	5,609	5,889	5,889	6,183	6,554	7,046
Oher credits	484	518	605	605	605	605
Deposits of central government	-1,941	-1,941	-1,941	-1,844	-1,752	-1,664
Net claims on local government	-24	-22	-247	-248	-248	-248
Claims on local government	232	236	236	241	246	251
Deposits of local government	-256	-258	-484	-489	-494	-498
Credit to the economy	33,378	38,110	39,010	45,212	51,631	58,454
Credit to public enterprises	422	443	464	499	524	550
Credit to private sector	32,945	37,656	38,546	44,713	51,107	57,905
Claims on nonbank financial institutions	11	11	0	0	0	0
Net claims on the Bank of Cape Verde	13,473	14,717	17,318	19,939	23,600	28,038
Total reserves	13,500	13,902	14,099	14,553	16,298	18,273
Vault cash	1,058	1,205	1,138	1,277	1,429	1,601
Deposits with central bank	12,443	12,697	12,960	13,277	14,870	16,672
Required reserves	11,052	12,117	11,045	12,457	14,001	15,752
Excess reserves	1,391	579	1,916	820	869	920
Credit to the Bank of Cape Verde	-27	815	3,220	5,385	7,301	9,764
Other items (net)	-7,587	-7,587	-7,684	-7,684	-7,684	-7,684
Deposit liabilities to nonbank residents	65,009	74,047	76,626	85,948	96,151	107,748
Local currency deposits	61,650	70,232	72,680	81,536	91,230	102,247
Demand deposits	21,084	24,156	25,020	28,249	31,787	35,806
Of which: emigrant deposits	3,394	3,756	3,885	4,343	4,845	5,415
Quasi money	40,566	46,076	47,660	53,287	59,443	66,441
Time deposits	38,390	43,605	45,103	50,429	56,255	62,877
Of which: emigrant deposits	23,825	26,367	27,273	30,493	34,016	38,020
Other quasi monetary deposits	2,176	2,471	2,556	2,858	3,188	3,564
Foreign currency deposits	3,359	3,815	3,946	4,412	4,922	5,501
Of which: emigrant deposits	1,100	1,217	1,259	1,407	1,570	1,755
Memorandum items:						
Emigrant deposits (as ratio to total deposits)	0.44	0.38	0.42	0.42	0.42	0.42
Composition of emigrant deposits						
Local currency	0.96	0.96	0.96	0.96	0.96	0.96
Demand	0.12	0.12	0.12	0.12	0.12	0.12
Time	0.84	0.84	0.84	0.84	0.84	0.84
Foreign currency	0.04	0.04	0.04	0.04	0.04	0.04

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

Table 8. Cape Verde: Proposed Work Program 2007–09

Mission Date	Purpose	Board Review
February 2007	Discussions on the second review against end-December 2006 assessment criteria	End-April 2007
August 2007	Discussions on the third review against end-June 2007 assessment criteria	End-October 2007
February 2008	Discussions on the fourth review against end-December 2007 assessment criteria	End-April 2008
August 2008	Discussions on the fifth review against end-June 2008 assessment criteria	End-October 2008
February 2009	Discussions on the sixth review against end-December 2008 assessment criteria	End-April 2009

APPENDIX I

CAPE VERDE: LETTER OF INTENT

22 December 2006

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

Dear Mr. de Rato:

1. In July 2006 the IMF Executive Board approved the request of the government of Cape Verde for a three-year Policy Support Instrument (PSI). The PSI is designed to support the government's economic objectives and policy framework for 2006–09. The new program focuses in particular on measures to consolidate macroeconomic stability, improve public sector management, reduce fiscal risks—including risks stemming from state-owned enterprises, and strengthen the financial sector. Details of the economic program being supported by the PSI are set out in the Memorandum of Economic and Financial Policies (MEFP) that was signed by the Minister of Finance and Public Administration on July 11, 2006.[1]

2. The attached memorandum updates the initial MEFP. It gives particular attention to policy developments and prospects for 200607, and reflects understandings reached *ad referendum* with an IMF staff team during discussions on the first review of the PSI in November 2006. In this update, the government signals its ongoing commitment to pursue macroeconomic and structural policies in support of sustained growth and poverty reduction.

3. The government believes that economic and policy developments under the PSI have been largely satisfactory to this point, including with respect to the key program objectives of reducing government domestic debt and increasing official foreign exchange reserves. The end-September structural assessment criterion concerning implementation of the automatic adjustment mechanism for electricity and water tariffs was missed, however, as a result of delays brought about by the change in the ownership structure of Electra in September.

[1] This MEFP is included in the Staff Report for the 2006 Article IV Consultation and Request for a Three-year Policy Support Instrument, and is available on the IMF website www.imf.org.

Based on the corrective actions being taken in this area (as discussed in the attached memorandum), the government requests a waiver for missing this deadline.

4. The government also requests a waiver for the end-September criterion concerning non-accumulation of domestic arrears that was missed, primarily because of accumulation of new arrears to Electra from semi-autonomous government entities. The attached memorandum sets out firm and direct measures the government intends to take to correct this problem.

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

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

Sincerely yours

/s/

Cristina Duarte
Minister of Finance and Public Administration.

APPENDIX I, ATTACHMENT I

CAPE VERDE: MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

UPDATE

I. INTRODUCTION

1. In this updated Memorandum of Economic and Financial Policies (MEFP), the government of Cape Verde re-confirms its commitment to pursue sound macroeconomic and structural policies to underpin the country's growth and development. Macroeconomic results and prospects for 2006 are largely exceeding expectations at the start of the PSI program. Supported by the firm fiscal and monetary stance that will be maintained in 2007, the government is determined that the program will remain on track next year and beyond. The government has also established an inter-agency unit to ensure that macroeconomic analysis and policy formulation takes place on a more coordinated basis and is consistent with objectives set under the PSI program. As discussed below, progress on structural reforms to strengthen such areas as public sector management, the financial sector, and the energy sector will add further support to the macroeconomic policy stance.

2. Through the PSI program, the government also signals to the international community its commitment to pursue sound economic policies in support of growth, development, and poverty reduction. In this regard, the government is grateful for the strong external assistance received over 2006, including partial debt relief, and hopes that this support will be broadened, deepened, and prolonged.

II. GROWTH AND INFLATION

3. **Cape Verde's economic performance remains strong.** Recent data indicate that business confidence is high, tourist numbers have picked up significantly, and inflows of foreign direct investment (FDI)—together with investment intentions—have also accelerated. Furthermore, abundant rainfall during 2006 is supporting stronger agricultural output—which will show up mainly in 2007—and reinforcing recent reductions in food prices. While economic activity in 2006 may have been held back by difficulties with electricity supply during the summer and by recent shortages in some construction sector inputs, it appears on balance that 2006 GDP growth may be somewhat stronger than the previous projection—possibly around 5.8 percent. Similarly, the growth projection for 2007 has been revised up to 6.5 percent, reflecting in part the stronger agricultural prospects noted above and carry-over effect from the strong FDI inflows during 2006.

4. **Consumer inflation is falling rapidly following a short-lived upturn earlier in 2006**. This rise in inflation resulted mainly from the impact of higher international oil prices on domestic energy and water prices, and from temporary supply shortages in a few food

items that are now being reversed. Twelve-month inflation is now projected to reach 3.3 percent by December 2006 (compared with December 2005), and 0.4 percent in December 2007.[2]

III. Fiscal Developments and Prospects

5. **The government remains committed to a medium-term fiscal strategy focused on maintaining macroeconomic stability, reducing fiscal risks, and creating fiscal space to prepare for potential future pressures on the budget.** Fiscal developments during 2006 and the outlook for 2007 are fully in line with these objectives and with the associated quantitative targets set out in the initial MEFP and updated in the current memorandum. In particular, the quantitative assessment criterion on net domestic borrowing of the central government was satisfied during the first three quarters of 2006 and, based on current trends, the fiscal stance is also on track toward meeting the December target for this measure (see Table 1). This outcome would allow domestic debt to be reduced to 26.9 percent of GDP by the end of 2006, down from 33.5 percent at end-2005 and in line with the goal of reaching a domestic debt ratio of 20 percent of GDP by 2009.

6. **The draft budget for 2007, now with the National Assembly, reinforces the government's commitment to fiscal discipline.** With wage and salary spending firmly contained, recurrent public spending is budgeted to decline as a share of GDP. This restraint will enable spending on the public investment program and other high priority areas to be maintained without putting at risk the program's overall fiscal objectives. In addition, the budget incorporates relatively modest projections for revenue growth, especially in light of the stronger-than-expected revenue performance now projected for 2006. Reflecting these developments, government net domestic borrowing, net of arrears clearance and late payments, will be limited to at most CVEsc -0.8 billion through end-June 2007 and to CVEsc -1.63 billion through end-December 2007. As a result, domestic debt would fall to around 21.0 percent of GDP at end-2007.

7. **The government is implementing a number of structural reforms to improve public sector financial management, strengthen revenue performance, and reduce fiscal risks.** Key measures include the following:

- A new macroeconomic policy unit is being established in the Ministry of Finance. This unit will focus on strengthening the formulation of fiscal policy by anchoring this process within the broader context of overall macroeconomic trends, prospects, and objectives. The unit will be fully staffed and operational by end-March 2007.

[2] On an annual average basis, inflation would be 4.9 percent in December 2006 and 0.2 percent in December 2007.

- A resource mobilization unit is also being set up in the Ministry of Finance. This unit will focus on identifying potential financial resources for approved projects. In support of this role, the unit will make certain that projects to be funded have been subject to sound and verifiable cost-benefit analyses. It will also complement the work of the Treasury in ensuring that proposals for financing remain consistent with overall debt sustainability considerations. This unit will be fully operational by end-March 2007.

- The government intends to submit two significant pieces of draft legislation to the National Assembly in 2007 aimed at strengthening the tax base. First, a revised income tax code is currently being prepared and, following a consultative process, will be submitted by end-June 2007. Second, preparation of draft legislation to streamline tax incentives and exemptions will begin shortly and will also be submitted by end-June 2007.

- Emphasis will be given to capacity building in accounting practices, directed at ensuring that the execution of the budget is appropriately reflected in the public accounts. These efforts should help improve the reconciliation between data on stocks and flows, and reduce errors and omissions in the accounts.

- Supported by technical assistance, procedures and capacities for debt management—covering both external and domestic debt—are also being substantially strengthened.

- Other structural-fiscal measures are progressing in line with program objectives. The medium-term expenditure framework will be implemented by end-June 2007, supported by a strengthening of the role of line ministries in expenditure planning. Laws to strengthen the Court of Auditors (TdC) and the National Chart of Public Accounts will also be implemented by end-June 2007.

8. **Following the significant efforts have been made to clear past arrears of central and local government entities, the government recognizes that firm measures are needed to prevent a recurrence of the arrears build-up.** As noted below, for example, arrears from municipalities and semi-autonomous public entities to Electra continue to undermine this company's operational performance. The online system (SIGOF) for budget execution and monitoring is being extended across the general government sector, including to municipalities and semi-autonomous public entities, with full implementation expected in 2008. The government will ensure that the application of SIGOF is backed by suitable control measures, so that this system provides an effective tool for preventing accumulation of arrears and strengthening financial discipline more generally. Even before SIGOF is fully operational, the government will take direct measures to prevent arrears:

- Drawing on direct reports from Electra and other sources as necessary, the Treasury will regularly monitor whether any central government entities, including the semi-autonomous services, have accumulated payment arrears. If this problem appears, the

Treasury will make the required payments on behalf of the entities concerned and deduct the corresponding amounts from government transfers to these organizations.

- As part of its public accountability plan, the government will continue to improve the training of personnel in all government services to strengthen budget management.

- As for municipalities, the government will fully enforce the new law on local finances to improve financial discipline at the local level. If the arrears problems persists in this area, however, the government will propose legislative reforms to enable the same direct measures as set out in the first point above to be applied.

IV. Monetary and Financial Sector Developments

9. **The accumulation of international reserves by the Bank of Cape Verde (BCV) remains strong.** Through the third quarter of 2006, the BCV's reserve build-up significantly exceeded the program target, and the same result is expected with respect to the end-2006 objective. This would imply that official reserves would reach at least 3.4 months of prospective imports by the end of 2006. For 2007, the BCV intends to increase reserve coverage by at least a further 0.1 months of prospective imports. To support its goal of strengthening the operational framework for monetary policy, the BCV will continue to assess the most appropriate set of intermediate monetary indicators to guide liquidity management and overall policy conduct.

10. **As part of its policy for financial sector development, the government is determined to ensure that international best practices are followed in this sector, including among international financial institutions in the offshore center.** Hence, financial sector development will be taken at a cautious pace, with appropriate measures in place to protect the system against potential financial abuse, to safeguard Cape Verde's reputation, and ensure the country's continued access to international financial markets. A number of activities are currently under way, including a consultancy contract, to assess the legal and institutional framework for the financial sector and to propose recommendations for its strengthening and development. Information and sensitization initiatives are an important part of the BCV's actions in the context of financial sector development, thus allowing the BCV to promote international best practices, namely with regard to offshore financial institutions and onshore specialized financial activities. In this context, various discussion sessions and capacity building initiatives will be held, drawing together renowned international experts, lawmakers, government officials, local private institutions and individual experts, and law enforcement agencies. Further, bottlenecks which constrain the development of various financial activities, namely those related to scope of activities, approval procedures, capital requirements, and regulated service fees are currently being removed. Specific recommendations from the consultancy will be formulated by end-December 2006 and acted on in the context of the BCV's 2007 work plan, with the goal of implementing the proposed reforms by mid-2007 in line with the current program

benchmark. Drawing in part on the results of a forthcoming needs assessment mission, the BCV will also ensure that the institution's capacity for financial market supervision keeps pace with growth in the financial system. In addition, the authorities will bring the framework for anti-money laundering and combating the financial of terrorism (AML/CFT) into line with international standards, drawing on the results of external assessments of the current legislation in this area.

V. Other Structural Reforms

11. **With Cape Verde having recently re-acquired majority ownership of Electra, the government is committed to solving the range of problems that have persistently undermined Electra's commercial viability and delayed much-needed investment in the sector.** In particular, Electra's new management team has been given a clear mandate by the government to run the company according to a private market philosophy, including with respect to pricing. To support this mandate, several measures are being taken to strengthen Electra's commercial operations:

- Following consultations between ARE, Electra, and the government, an agreement on the new mechanisms to set and adjust tariffs for electricity and water was signed on 30 November 2006. The mechanisms will be fully implemented by March 2007.[3]

- As noted earlier, the government will give urgent attention to preventing the occurrence of new payment arrears to Electra from the public sector.

- The government fully agrees with the need for Electra's to improve its billing and collection practices for private clients and to reduce illegal electricity and water connections. In this regard, the government will assess whether these efforts need to be backed by regulatory reforms to strengthen Electra's ability to bill clients.

12. **Electra's investment program addresses much needed and long overdue projects that would lead to significant improvements in the company's operational efficiency and capacity.** The government is calling a donor roundtable in 2007 with the goal of attracting external concessional support to support this investment program. The authorities will also continue to explore additional financing prospects and possibilities: these could include borrowing from domestic banks, possibly under government guarantee, and/or accelerating the agreed timetable for clearing government arrears to Electra to add to the company's own resources. In the event that sufficient financing is not available from domestic sources or from highly concessional external sources, the company may also need

[3] A new end-March 2007 assessment criterion for the second review. Criteria for full implementation of the tariff adjustment mechanism are set out in paragraph 17 of the Technical Memorandum of Understanding that accompanies the MEFP.

to consider external financing on nonconcessional terms, probably under government guarantee. To accommodate this option and support high priority, high return investment projects of Electra, the government requests that the ceiling under the PSI program on nonconcessional government and government guaranteed external borrowing be raised from the current $20 million per year to $35 million. The government recognizes that the measures set out above to strengthen Electra's operating environment are essential pre-conditions to support the return on investment projects, limit fiscal risks, and preserve debt sustainability.

13. **The mechanism for adjusting retail fuel prices according to changes in import prices is not working as originally envisaged, and improvements are needed in the transparency, automaticity, and regularity of these adjustments.** The government has formed an inter-agency task force to address this concern, drawing on the work of an outside consultant. In particular, this task force will assess whether the objective of having automatic, transparent, and regular updates in fuel prices can be met through more effective application of the current mechanism, or whether changes in this mechanism are required. The task force's recommendations will be finalized by end-June 2007 and the government will act on these without delay.

14. **The government remains committed to completing its privatization agenda, including for TACV and ENAPOR.** The restructuring of TACV is progressing and, as part of this process, the company has recently agreed to purchase three new aircraft; these will be acquired under a financial lease arrangement without government guarantee. Following a bidding conference for ENAPOR scheduled for February 2007, bidding is expected to get underway in April 2007.

VI. PROGRAM MONITORING

15. **This MEFP Update proposes new quantitative and structural assessment criteria and benchmarks for end-June 2007 and end-December 2007 (**for the third and fourth reviews, respectively; see Tables 1 and 2 attached). Definitions of terms and specification of reporting requirements are contained in the technical memorandum of understanding (TMU). The second review, scheduled to be completed by end-April 2007, is expected to give particular attention to the utility tariff and petroleum price adjustment mechanisms, the financial sector action plan and reforms, and measures to enhance external financing flexibility. The third and fourth reviews are scheduled to be completed by end-October 2007 and end-April 2008, respectively.

Table A1. Cape Verde: Quantitative Assessment Criteria and Benchmarks for 2006–07 Under the PSI [1, 2]

	2005	Cumulative Flows from End-December, 2005							Cumulative Flows from End-December, 2006			
		2006							2007			
	Dec.	June			Sep.			Dec.	March	June	Sep.	Dec.
	Level Actual	Indicative Target	Adjusted Indicative target	Prel.	Assessment Criteria	Assessment Criteria w/ adjusters	Prel.	Assessment Criteria	Indicative Target	Assessment Criteria	Indicative Target	Assessment Criteria
Quantitative targets					(Billions of Cape Verde escudos)							
Ceiling on net domestic borrowing of the central government [3]	...	-0.9	0.0	-1.8	-1.4	-1.3	-1.4	-1.8	-0.4	-0.8	-1.2	-1.6
Ceiling on net domestic assets of the central bank [4]	5.8	-0.4	0.5	-1.7	-0.6	-0.6	-3.8	-0.9	-0.6	-1.2	-1.7	-2.3
Ceiling on the accumulation of new domestic payment arrears by the central government	...	0.0	0.0	0.03 [5]	0.0	0.0	0.1 [5]	0.0	0.0	0.0	0.0	0.0
					(Millions of U.S. dollars)							
Ceiling on the accumulation of new external payment arrears by the central government [6]	0.0	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 [7]	...	10.0	10.0	...	10.0		3.2	20.0	5.0	21.0	28.0	35.0
Ceiling on the outstanding stock of nonconcessional external debt with a maturity of less than one one year by the central government [6, 8]	0.0	0.0	0.0	...	...		...	0.0	0.0	0.0	0.0	0.0
					(Millions of euros)							
Floor on net international reserves of the Bank of Cape Verde (BCV) [9]	137.0	9.5	8.6	11.6	13.8	13.8	42.6	19.0	8.0	15.9	23.2	31.8
Memorandum item:					(Billions of Cape Verde escudos)							
Program assumptions												
Nonproject external financial assistance, including credit line (program assumption)	...	1.6	...	0.6	2.3		2.1	3.1	0.7	1.4	2.2	2.9
External debt service	...	1.3	...	1.3	2.0		1.8	2.6	0.7	1.3	2.0	2.6
Clearance of end-2005 stock of domestic arrears	...	0.9	...	0.3	1.3		0.9	1.7	0.3	0.5	0.8	1.0

[1] Quantitative assessment criteria and benchmarks are described in the technical memorandum of understanding.
[2] For purposes of calculating program adjusters, foreign currency amounts will be converted at current exchange rates.
[3] Excluding borrowing for clearance of arrears and net late payments. The ceiling will be adjusted downward (upward) by the cumulative downward (upward) deviations in external debt service and upward (downward) by the cumulative downward (upward) deviation in nonproject external financial assistance relative to program assumptions.
[4] The ceiling will be adjusted downward (upward) by the cumulative downward (upward) deviations in external debt service and upward (downward) by the cumulative downward (upward) deviation in nonproject external financial assistance relative to program assumptions.
[5] Includes accumulation of arrears to Electra only. Data on accumulation of other domestic arrears are not available.
[6] This assessment criterion is on a continuous basis.
[7] This assessment criterion (including for the end-December 2006 test date) is assessed on a quarterly basis and not on a continuous basis as stated in the TMU attached to the Letter of Intent dated July 11, 2006. The criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85), August 24, 2000), but also commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are rescheduling arrangements, the Portuguese credit line, and borrowings from the Fund.
[8] The term "debt" has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt. Excluded from this performance criterion are rescheduling arrangements, the Portuguese credit line, borrowings from the Fund, and normal import-related credits.
[9] 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.

Table A2. Structural Assessment Criteria and Benchmarks for 2006–07

Objectives	Conditionality	Timing	Status
	Structural Assessment Criteria		
Reduce fiscal risks	Complete implementation of the automatic utility tariff adjustment mechanism	End-September 2006	Not met
	Structural Benchmarks		
Strengthen financial regulations	Complete Action Plan of task force assessing measures to ensure that financial sector regulation and supervision is in line with best international practice, including provisions applying to IFIs and AML/CFT	End-September 2006	In preparation
Strengthen fiscal strategy	Establish macroeconomic policy unit in the Ministry of Finance and Public Administration	End-December 2006	Met
Strengthen financial supervision	Sign formal information sharing agreements with home country supervisors of subsidiaries and branches established in Cape Verde	End-December 2006	
Improve budget prioritization	Implementation of the MTEF	End-June 2007	In preparation
Strengthen financial regulations	Implement recommendations of task force on financial sector reform (see above)	End-June 2007	
Streamline tax incentives	Submit draft legislation to National Assembly on streamlining of tax incentives and exemptions	End-June 2007	
Strengthen fiscal control	Implement laws to strengthen the Court of Auditors (TdC) and National Chart of Public Accounts	End-June 2007	

Table A3. Supplementary Structural Assessment Criteria and Benchmarks for 2006–07

Objectives	Conditionality	Timing	Status
	Structural Assessment Criteria		
Reduce fiscal risks	Full implementation of the automatic utility tariff adjustment mechanism	End-March 2007	
	Structural Benchmarks		
Strengthen tax base	Submit the revised income tax code to the National Assembly	End-June 2007	In preparation

APPENDIX I, ATTACHMENT II

CAPE VERDE: TECHNICAL MEMORANDUM OF UNDERSTANDING

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

I. QUANTITATIVE ASSESSMENT CRITERIA AND INDICATIVE TARGETS

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

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

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

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

nonbank financing; (ix) privatization and land sale receipts; and (x) any other revenue, expenditure, or financing not included above.

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

B. Net Domestic Assets of the Central Bank

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

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

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

8. Under the program, ceilings on medium- and long-term, as well as on short-term, nonconcessional external debt constitute assessment criteria. The ceiling on medium- and long-term nonconcessional external debt is on a quarterly basis while the one on short-term nonconcessional external debt is on a continuous basis. Nonconcessional external debt is defined as debt contracted or guaranteed by the central government with a grant element of less than 35 percent, calculated using currency-specific commercial interest reference rates (CIRRs) published by the Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD). Debt rescheduling and debt reorganization are excluded from the limits on nonconcessional external debt. The limits on new nonconcessional external debt contracted or guaranteed by the central government (excluding borrowing from the Fund) are specified in Tables 1 and 2 of the memorandum of economic and financial policies. The definition of short-term nonconcessional external debt excludes normal short-term (less than one year) import-related financing. The Portuguese government's precautionary credit line in support of the exchange rate peg is also excluded from the definition of nonconcessional external debt. The assessment criterion on medium- and long-term nonconcessional external indebtedness applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt

(Decision No. 12274-(00/85), 8/24/00) but also to commitments contracted or guaranteed for which value has not been received. With respect to the assessment criterion on short-term nonconcessional external indebtedness, the term “debt” has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85), 8/24/00).

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

D. Net International Reserves of the Central Bank

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

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

E. Nonaccumulation of New Domestic Payments Arrears

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

the timing of the payment is subject to good faith negotiations between the government and the creditor.

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

F. Nonaccumulation of External Payments Arrears

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

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

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

II. Structural Assessment Criteria[1]

A. Complete Implementation of the Automatic Utility Tariff Adjustment Mechanism

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

III. Other Data Requirements for Program-Monitoring Purposes

18. Data on exports and imports, including volume and prices and compiled by the Director of Customs and the BCV, will be transmitted on a quarterly basis within five weeks

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

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.

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

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

APPENDIX II

CAPE VERDE: RELATIONS WITH THE FUND

(As of October 31, 2006)

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

II. General Resources Account:	**SDR Million**	**%Quota**
Quota	9.60	100.00
Fund holdings of currency	9.59	99.93
Reserve Position	0.02	0.17
Holdings Exchange Rate		

III. SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	0.62	100.00
Holdings	0.03	4.74

IV. Outstanding Purchases and Loans:	**SDR Million**	**%Quota**
PRGF Arrangements	8.64	90.00

V. Latest Financial Arrangements:

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

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

				Forthcoming	
	2006	2007	2008	2009	2010
Principal		0.12	0.49	0.98	1.48
Charges/Interest	0.03	0.07	0.07	0.06	0.06

VII. Implementation of HIPC Initiative: Not Applicable

VIII. Implementation of MDRI Assistance: Not Applicable

IX. Safeguards Assessments

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

X. Exchange Arrangements

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

XI. Article IV Consultation

Discussions for the 2006 Article IV consultation and on a medium-term economic program that could be supported by a three-year PSI were held in Praia on April 28–May 16, 2006. The Executive Board concluded the discussions of the 2006 Article IV consultation and approved the request for a PSI on July 31, 2006 (Country Report No. 06/334, dated 07/14/06); and www.imf.org.

XII. Technical Assistance

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

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

FAD

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

STA

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

MFD

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

XIII. Resident Representative: None.

APPENDIX III

CAPE VERDE: IMF-WORLD BANK RELATIONS

(June 16, 2006)

Partnership in Cape Verde's development strategy

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

World Bank-Fund collaboration in specific areas

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

World Bank Group strategy

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

World Bank Group activities and assessment of country policies

IDA portfolio

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

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

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

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

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

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

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

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

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

Assessment of country policies

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

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

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

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

Statement of IDA Operations

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

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

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

Statement of IFC Investments

(Millions of U.S. dollars)

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

[1] Growela = shoe manufacturing.

[2] CECV = Caixa Economica de Cabo Verde.

APPENDIX IV

CAPE VERDE: STATISTICAL APPENDIX

1. **The quality of Cape Verde's economic and financial data are generally adequate for surveillance and program monitoring, although there is need for substantial improvements in some areas.** Weaknesses in the fiscal data hamper the monitoring of some aspects of fiscal performance. Weaknesses include large statistical discrepancies in the provisional quarterly data (which stem from poor recording of some operations) and shortcomings in the institutional coverage and sectorization, budgetary reporting, basis of recording, and coverage of asset and liabilities, Other shortcomings of particular concern are weaknesses in the national accounts, an outdated CPI that lacks sufficient details to adequately track the sources of inflation pressure, a lack of short-term activity indicators besides the confidence barometer, and gaps in the tracking of large external flows—notably FDI, emigrant deposits, and remittances.

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

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

Real sector

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

in 2005 and providing production based GDP estimates for 2004–05 to the mission in May 2006. However, the lag is still large when compared to international standards. The base year for the constant price estimates is outdated, although INE is currently working on a complete overhaul of the national accounts. The overhaul includes updating the national accounts benchmark and base years from 1980 to 2002, and adopting the *1993 SNA*. The ultimate objective is the timely compilation of GDP by industry and expenditure categories at current and constant prices as well as the institutional sector accounts.

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

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

Government finance

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

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

9. **The Government Finance Statistics (GFS) compilation system is being upgraded as part of the ongoing reforms of the government's management and information systems.** Most accounts previously held with commercial banks have been consolidated at

the central bank. In addition, government agencies' reporting, as well as the coordination among the treasury, the budget directorates, and the central bank, have improved, with the Ministry of Finance and Planning being the single point of commitment, execution, and monitoring of public expenditure.

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

Money and banking

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

Balance of payments

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

External debt and arrears

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

Cape Verde: Common Indicators Required for Surveillance

(As of June 27, 2006)

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

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

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

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

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

[5] Including currency and maturity composition.

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

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes the First Review Under the Policy Support Instrument for Cape Verde Cape Verde

The Executive Board of the International Monetary Fund (IMF) has completed the first review under a three-year Policy Support Instrument (PSI) for Cape Verde. The PSI was approved on July 31, 2006 (see Press Release No. 06/172).

Cape Verde's PSI is designed to help the country respond to the opportunities and challenges associated with its graduation from UN least-developed country (LDC) status in 2008. The program seeks to reduce macroeconomic risks, provide a margin of safety against exogenous shocks, and address the prospect of a longer-term decline in highly concessional external support.

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

Following the Executive Board's discussion of Cape Verde, on Monday, January 22, 2007, Mr. Murilo Portugal, Deputy Managing Director and Acting Chair, said:

“Cape Verde’s economic performance remains strong, supported by prudent macroeconomic policies and structural reforms being implemented. Economic growth, already quite robust, is being reinforced by significant increases in tourism and foreign direct investment; and inflation is expected to remain low in the medium term. Fiscal and monetary policies are on track to substantially reduce domestic debt and boost official foreign exchange reserves.

“The government’s budget for 2007 seeks to create fiscal space to meet potential future spending pressures. An essential element of the fiscal stance will be to end the problem of arrears accumulation by public sector agencies.

“Ensuring a stable supply of electricity and water at reasonable cost is crucial if Cape Verde is to realize its medium-term economic goals. Accordingly, the agreement reached between the electricity and water utility and the Economic Regulatory Authority on an automatic adjustment mechanism for electricity and water tariffs is welcome. The mechanism for adjusting retail fuel prices also needs to ensure that domestic prices reflect import prices. In general, public enterprises need to operate on commercial terms.

“As highly concessional financing may become increasingly difficult to secure after Cape Verde graduates from UN least-developed-country status in 2008, new external financing options may need to be developed. To ensure that this increased financing flexibility does not jeopardize long-term fiscal or debt sustainability, Cape Verde’s institutional capacity for project appraisal and implementation, debt management, and debt sustainability analysis will need to be strengthened,” Mr. Portugal said

Statement by Laurean W. Rutayisire, Executive Director for Cape Verde
January 22, 2007

On behalf of my Cape Verdean authorities, I would like to thank Management for the quality of relations that the IMF maintains with Cape Verde, and Staff for the constructive policy dialogue and candid exchange held during the discussions in Praia. My authorities share the view that the staff report accurately reflects the recent economic developments in Cape Verde and the challenges that the economy faces. They have consented to the publication of the report as well as their Letter of Intent and updated Memorandum of Economic and Financial Policies.

I. Background

Cape Verde has made significant progress in implementing sound policies and reforms under its past PRGF-supported program. Equipped with a solid poverty reduction strategy focused on promoting good governance, improving competitiveness and private-sector-led growth, fostering human capital development, strengthening social security and solidarity, and improving infrastructure and land use management, the country has importantly reduced poverty, placing itself on a path out of the low-income countries group. These achievements enabled it to become one of the first countries to qualify for U.S. assistance under the Millennium Challenge Corporation.

My Cape Verdean authorities intend to move the country further in the economic ladder and make it soon an emerging market economy. However, the important development challenges that remain must be addressed. These challenges include reducing macroeconomic risks, increasing Cape Verde's resilience to exogenous shocks, and preparing for the prospect of a long-term decline in highly concessional external support. My authorities are of the view that the PSI is best suited for achieving these main goals.

My authorities would like to renew their strong commitment to pursue sound macroeconomic and structural policies, in line with the PSI policy objectives. Macroeconomic policies have been consistent with the objectives of achieving stability and reducing the economy's vulnerability to external shocks. My authorities have also met the key program objectives of reducing government domestic debt and increasing official foreign exchange reserves.

Two end-September criteria were missed on account of constraints related to the electricity sector. The structural assessment criterion concerning implementation of the automatic adjustment mechanism for electricity and water tariffs was not observed because of delays brought about by change in the ownership structure of the electricity and water company, Electra, in September 2006. It is important to remind that the return of the utilities company to state ownership was motivated by the frequent interruptions in electricity supply throughout the first half of 2006 and the daunting weaknesses associated with lack of investment in production capacities, high commercial losses and poor bill collection rates.

The missed criterion concerning non-accumulation of domestic arrears owes to financial difficulties on the part of semi-autonomous government entities which failed to honor obligations vis-à-vis Electra. Nevertheless, firm corrective actions are being taken by my authorities in both areas of missed criteria, and they are strongly confident that they will reach satisfactory outcomes in a reasonable time horizon. On this basis, my authorities request waivers for the non-observance of the two missed criteria.

Given the authorities' strong track record of policy and reform implementation, the positive fiscal and monetary developments and prospects going forward, and min light of their unwavered commitment to the PSI program objectives, I would like to request, on behalf of my authorities, the completion of the first review under the PSI.

II. Recent Macroeconomic Performance and Reforms

Cape Verde's economy has continued to perform remarkably well, despite difficulties with electricity supply and recent shortages in some inputs for the construction sector. According to provisional data, GDP growth in 2006 may have exceeded the projected level, at around 5.8 percent, and inflation is contained following a short-lived surge due to oil price s increase and temporary food supply shortages. The business confidence is high, activity in the tourism sector is buoyant, and FDI inflows are on an accelerating mode. Growth in 2006 was also supported by stronger agricultural output owing to abundant rainfall, much of which will be reflected in 2007 production. Accordingly and taking account of carry-over effects from FDI inflows, the growth projection for 2007 has been revised upward to 6.5 percent.

As regards fiscal and debt policy, the fiscal stance in 2006 has been oriented towards consolidation and fully in line with the medium-term strategy focused on maintaining macroeconomic stability and reducing fiscal risks. My authorities have improved capacity to implement public investment projects and efforts have been made to reduce lags in donor reporting. However, investment levels have been low. To create room for increased capital spending, current spending—including in wages and pensions— is being reduced.

On the revenues side, significant efforts have been made, resulting in improved customs collections also supported by strong import growth. The quantitative assessment criterion on net domestic borrowing of the central government was met in all quarters of 2006, allowing domestic debt to be reduced to about one-quarter of GDP, down from one-third at end-2005. The current fiscal stance allows for optimism about meeting the domestic debt ratio of 20 percent of GDP by 2009.

On the monetary and financial sector front, the strategy of official reserves accumulation is bearing satisfactory results. Indeed, the central bank's reserves build-up significantly exceeded the program target through the third quarter of 2006, and the same result is expected with respect to the December 2006 objective, bringing official reserves to at least 3.4 months of prospective imports by the end of 2006.

Concerning structural reforms, important strides have been made, including among others the setting-up of a macroeconomic policy unit in the Ministry of Finance and Public

Administration; the establishment of an interagency unit to ensure that macroeconomic analysis and policy formulation are better coordinated and remain consistent with PSI objectives; ongoing preparation of a draft action plan for financial sector development; and agreement with Cape Verde Telecom to fully liberalize the telecommunications market in early 2007, with the view to lower international rates, raise land line charges and attract additional service providers.

III. Macroeconomic Policies Going Forward

As noted above, my authorities intend to maintain a sound policy implementation over the medium-term. Specifically, as regards the **fiscal and debt policy**, the draft budget for 2007 has been submitted to the National Assembly. It reinforces the government's commitment to fiscal discipline through firm containment of recurrent spending as a share of GDP. This is intended to create fiscal space for public investment and spending in other high priority areas without putting at risk the program's overall fiscal objectives. This stance is expected to further lower domestic debt to around 21 percent of GDP at end-2007.

My authorities will continue to implement a number of fiscal-related reforms to improve public financial management, strengthen revenue performance and reduce fiscal risks. Besides the establishment of macroeconomic policy and resource mobilization units within the Ministry of Finance, other fiscal measures envisaged include the strengthening of the tax base through a revision of the income tax code and the streamlining of tax incentives and exemptions; capacity building in accounting practices; strengthening of procedures and capacities for debt management and the implementation by en-June 2007 of the medium-term expenditure framework.

To avoid the recurrence of domestic arrears build-up by municipalities and semi-autonomous public entities vis-à-vis Electra, my authorities are extending the online system SIGOF for budget execution and monitoring across the general government sector, including these entities, with full implementation expected in 2008. In the meantime, other measures to prevent arrears will be put in place, notably: (i) the monitoring and payment by the Treasury of any arrears accumulated vis-à-vis the utilities company Electra by central government entities; (ii) continued improvement in the training of personnel of all government services to strengthen budget management; and (iii) full enforcement of the new law on local finances to improve financial discipline at the local level and—if necessary—legislative reforms to apply the same direct measures as laid out in (i).

On **monetary policy**, the BCV, to support the exchange rate peg, intends to pursue its strategy of foreign reserves accumulation and strengthening of monetary policy operations. The central bank is targeting a further reserves growth of 0.1 months of prospective imports in 2007. The operational framework for monetary policy will be strengthened through BCV assessing the most appropriate set of intermediate monetary indicators to guide liquidity management and overall policy conduct.

Concerning the **financial sector,** the Cape Verdean authorities are determined to ensure that international best practices are followed, including among international financial institutions

in the offshore center. They will put in place appropriate measures to protect the system against potential financial abuse, to safeguard Cape Verde's reputation, and to ensure the country's continued access to international financial markets. Information and sensitization initiatives are an important part of the BCV's actions in the context of financial sector development, that will also allow the BCV to promote international best practices.

IV. Structural Reform Agenda

Regarding **sectoral reforms**, the government is committed to solving the range of problems that have persistently undermined Electra's commercial viability and delayed investment in the *electricity sector*. Although owned at 51 percent by the state, the utilities company is being run according to private market philosophy, including with respect to pricing. As highlighted above, the government is giving urgent attention to prevent the occurrence of new payment arrears to Electra from the public sector. To complement its resources to implement its investment program, Electra may need to consider external financing on nonconcessional terms. This would require raising the ceiling under the PSI program on nonconcessional government and government-guaranteed external borrowing from $20 million per year to $35 million. We call on the Board to support such ceiling adjustment, given the critical importance of this sector and the long overdue investment projects.

In the *retail fuel area*, my authorities recognize that the mechanism for adjusting prices according to changes in import prices is not working as originally envisaged, and improvements are needed in the transparency, automaticity, and regularity of these adjustments. Thus, they have formed an inter-agency task force to address this concern, drawing on the work of an outside consultant. In particular, this task force will assess whether the objective of having automatic, transparent, and regular updates in fuel prices can be met through more effective application of the current mechanism, or whether changes in this mechanism are required. The task force's recommendations will be finalized by end-June 2007 and the government will act on these without delay.

The government remains committed to completing its **privatization agenda**, including for TACV, and ENAPOR. The restructuring of the airlines company, TACV, is progressing well and, as part of this process, the company has recently agreed to purchase three new aircrafts through a financial lease arrangement without government guarantee.

On **financial sector reforms**, bottlenecks which constrain the development of various financial activities, namely those related to scope of activities, approval procedures, capital requirements, and regulated service fees are currently being removed. Drawing in part on the results of a forthcoming needs assessment mission, the BCV will also ensure that the institution's capacity for financial market supervision keeps pace with growth in the financial system. In addition, the authorities will bring the framework for anti-money laundering and combating the financial of terrorism (AML/CFT) into line with international standards.

V. Conclusion

Cape Verde's economic and financial performance has continued to improve in the recent past, supported by the efforts made under the current PSI program. Nevertheless, the country continues to remain vulnerable to exogenous shocks and still faces important development challenges, notably facing external vulnerabilities and uncertainties concerning resources flows, improving the business climate with the view to further boost growth and reduce poverty, and diversify the economy. To address them, my authorities are determined to further the reform agenda in close collaboration with the Fund and other development partners, so that Cape Verde continues to make important strides towards becoming an emerging market economy. They remain confident that this can be achieved. In this regard, the pursuit of the PSI program is crucial. My authorities continue to view the PSI as the most suitable instrument to support their reform efforts, mobilize FDI inflows, and diversify the economy, so as to cushion it against external shocks.

My Cape Verdean authorities look forward to continued support from donors, and express gratitude for the recent assistance from the US Millennium Challenge Corporation and the UK government. They will continue to spend on poverty reduction the resources made available from donor aid.

In view of my authorities' continued remarkable track record and their commitment and full ownership of the required actions, I call for the continued support of the Fund Executive Board to Cape Verde.