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Introduction

1. On behalf of the authorities of Sao Tome and Principe (STP), we thank the Executive Board, Management and Staff for their continued engagement and support to the country's economic program. The authorities appreciate the quality discussions held in the context of the 2022 Article IV Consultation and the Fourth Review under the Extended Credit Facility (ECF) and broadly agree with staff's assessment and policy advice. They also would like to express their deep appreciation to the Fund for appointing the first resident representative in more than 18 years. The presence of a resident representation will help strengthen the relation with the IMF and deepen program implementation, particularly during such uncertain and challenging times for this small state facing significant capacity constraints.

2. In such environment exacerbated by the pandemic and climate-related shocks, the authorities have continued to implement their ECF-supported program in a satisfactory manner The authorities are nonetheless cognizant of the need to remain steadfast considering the remaining macroeconomic vulnerabilities and persistent development challenges which require continued support from the international community.

Recent Developments

3. The Covid-19 pandemic, electricity shortages, and natural disasters continue to take a toll on the economy. After a four-week surge with record-high cases of infection in early 2022, STP's fourth Covid-19 wave, which was mainly driven by the Omicron variant, has passed, prompting the easing of some restrictions. STP has made some progress with its goal to reach herd immunity with a vaccination rate of 70 percent by mid-2022. March 2022 data indicates that 51.4 percent of the population received the first dose, and 39.1 percent are fully immunized.

4. On December 28 and 29, 2021, STP was hit by torrential rains and floods, the most extreme climate event in the past three decades. This has caused significant suffering ranging from loss of human lives to property damages. The floods rendered the entire area of the capital city impassable. In addition, the flash floods destroyed several houses and the water treatment center in the city of Neves, and caused considerable damage in other sectors, notably agriculture. According to a report prepared by the government, the estimated costs for recovering damaged infrastructure, supporting businesses, and mitigating the effect on people's health and health services, amount to about $37.5 million, around 7 percent of GDP.

5. STP's economic growth slowed down to 1.8 percent in 2021 from 3.0 percent in 2020, reflecting a decrease in public investments, electricity shortages, and the weakening of the private sector, notably in the tourism area. This contributed to a decline in tax revenue While Covid-19 related assistance to vulnerable households and businesses increased, the authorities made efforts to contain and even reduce non-essential spending to reach the program's objectives. As a result, the fiscal deficit narrowed more than expected, from 3.8 percent of GDP in 2020 to about 3.3 percent at year-end 2021. Inflation has increased moderately to about 9.5 percent in 2021 as global oil and food price trends continue to exert pressure. The current account deficit has narrowed from 10.3 in 2020 to 9.6 percent in 2021 on the back of travel and export recovery, while gross international reserves stood comfortably at about 3.5 months of projected imports. Credit growth to the private sector slowed down during the period.

6. The authorities of STP appreciate the assistance received under the G-20's Debt Service Suspension Initiative (DSSI) endorsed by the Paris Club and under the Fund's Catastrophe Containment and Relief Trust (CCRT), which has continued to provide helpful debt service relief. It is also worth noting that STP has used half of its SDR allocation received in August 2021 to: (i) meet pandemic-related spending needs; and (ii) address health, education, transport, and energy infrastructure gaps, notably through renovations of hospitals, schools, and roads, and repairs of the power grid.

Performance under the ECF

7. Program implementation in STP has been broadly positive, despite the challenges imposed by the pandemic and electricity blackouts. While tax revenue underperformed, the authorities have continued their efforts to contain non-priority spending to ensure that the program remains on track. As a result, four out of five quantitative performance criteria (PCs) for end-June 2021 were met. The PC on net international reserve target was slightly missed due to lower-than-expected disbursements.

8. Regarding structural benchmarks (SBs), the pandemic and capacity constraints continue to impact the implementation of reforms, including the submission of Financial Institutions law, efforts to obtain the removal from the EU air safety blacklist, EMAE reforms, and the introduction of the VAT at a 15 percent rate. On the latter, the delay was fundamentally due to delays in developing the VAT IT system financed by the World Bank. To date, the contract is pending signature with the company that won the tender for the development of the IT application. The SB on the submission of the *Banco Central de Sao Tomé e Príncipe* (BCSTP) Organic Law to the Parliament was completed as a prior action. The authorities have also submitted to the Presidency of the Republic a decree that updates the price structure of petroleum products to prevent fuel subsidies and contain fiscal risks. Moreover, progress was made in maintaining transparency of Covid-19 spending and public procurement, albeit with minor delays. Measures in this regard include the submission of a

new draft procurement legislation requiring the collection and publication of beneficial ownership information, and continued publication of Covid-related expenditure reports and procurement contracts. The ex-post audit by the Auditor General of the 2020 Covid-19 related expenditures should be finalized in April 2022.

Outlook and Risks

9. Despite the impact of the floods on agriculture and trade, the authorities expect real GDP growth to accelerate to 2.3 percent in 2022 and firm up at around 4.0 percent over the medium-term as tourism and infrastructure growth pick up, and electricity supply stabilizes. Nonetheless, they are cognizant of the downside risks stemming from new Covid-19 variants, increased global fuel prices, supply chain disruptions, and natural disasters. Against this backdrop, they fully understand the importance of avoiding setbacks in fiscal adjustment and that of implementing key structural reforms in the energy sector. It should be emphasized however that the authorities are very concerned about the impact of the upcoming fuel price increase on the social environment, which could be more complicated by demands for a significant public sector wage increase. The authorities reiterate their commitments to the reforms under the program and to taking additional measures—after consulting with Fund staff—should risks materialize.

Policy Priorities for 2022 and Beyond

Fiscal Policy

10. The authorities continue to take the necessary steps to maintain the fiscal consolidation momentum. To achieve the 2022 revenue objectives and make room for flood and reconstruction response within the approved 2022 budget, actions are being taken to implement a new airport tax and a tax surcharge on alcohol beverages. Efforts are also being made to reinforce the monitoring and recovering of tax arrears from large taxpayers by collecting tax obligations suspended during the pandemic and forcefully applying existing legal procedures to ensure compliance. The VAT at a 15 percent rate is expected to be introduced by September 2022. To support this effort, the Tax Directorate has validated the first module of the VAT IT system for taxpayers' registration and a technical agreement has been reached between the Customs and Tax Directorates on the applicability of the VAT law at the Customs collection point. The VAT refund regulations, recently enacted by the President, have been harmonized with the excise tax decree and work is ongoing to also ensure its alignment with the stamp tax decree.

11. On the expenditure front, rationalization efforts will continue. A new Ministerial order was issued in February 2022 to freeze new hiring of civil servants to contain personnel costs, and contingency measures are in place to cut administrative costs by 20 percent should revenue underperform. Covid-19 spending will be rolled back when conditions allow. Regarding transparency, the government reiterates its commitment to continue to publish

information on public procurement contracts and monthly Covid-19 related expenses, including the beneficial ownership information. They acknowledge that the absence of an integrated system and other legal and operational constraints to collect and process information continues to lead to delays in publishing some information. In this regard, with the assistance of the World Bank and the IMF, a revised draft of the new Procurement Law, which incorporates beneficial ownership information collection and publication requirements, has been finalized. This, together with the website currently being developed for the procurement agency COSSIL will speed up the publication of documents and facilitate management and transparency over public contracts.

12. Over the medium-term, the authorities remain committed to undertake actions to (i) gradually reduce the wage bill to close to 10% of GDP by 2023-24 by limiting new hiring and halting inflation-based adjustments; (ii) maintain transfers and other current expenditures constant in nominal terms; and (iii) strengthen public financial management (PFM) and tax administration in line with IMF recommendations. On the latter point, significant progress was made on various fronts, including the incorporation of medium-term fiscal framework projections for a 3-year period in the 2022 budget documents and publication of the calendar of treasury bill auctions. The authorities also plan to undertake a comprehensive tax administration diagnostic assessment by end-2022.

Debt Policy and Management

13. The authorities concur with the results of the latest debt sustainability analysis (DSA), which indicates that the external debt is sustainable, despite the debt distress rating due to prolonged unsettled external arrears. They reiterate their commitment to continuing fiscal consolidation efforts as envisaged under the program and advance energy sector reforms to keep debt on a downward path and preserve its sustainability. They will also continue to pursue prudent debt management and keep engaging with creditors in an open and transparent manner to regularize arrears and restructure all outstanding debt.

Monetary and Exchange Rate Policies

14. BCSTP will continue to closely monitor systemwide liquidity to prevent liquidity tensions and stand ready to adjust monetary policy to safeguard the exchange rate peg to the Euro. They emphasize that the peg has been instrumental towards the Central Bank's primary objective of maintaining price stability and agree that building strong international reserve buffers is paramount, given the persistence of shocks the country faces. Therefore, sustaining fiscal consolidation efforts and advancing structural reforms aimed at bolstering competitiveness and energy efficiency will be important to help build larger reserve buffers.

15. The implementation of the outstanding recommendations of the 2019 Safeguard Assessment to improve the independence and transparency of the Central Bank is advancing well. The draft of the organic law has been approved by the BCSTP Board and submitted to

the Parliament as a prior action. Moreover, efforts are ongoing to enhance internal audit capacity, finalize the memorandum of agreement on legacy government debt, conclude the audit of financial statements and implement the International Financial Reporting Standards (IFRS). On the latter, the authorities look forward to Fund's technical assistance to make strides in the implementation. In addition, the BCSTP expects to finalize the revised draft Financial Institutions Law very soon and submit it to the government by end-June 2022 following consultation with Fund staff. The authorities also view preserving their membership in the Inter-Governmental Action Group against Money Laundering in West Africa (GIABA) as essential to protect the integrity of the country's financial system.

Financial Sector Policies

16. BCSTP expects to finalize the revised draft Financial Institutions Law very soon and submit it to the government by end-June 2022 following review and advice by Fund staff, with a view to strengthen financial supervision and improve governance and oversight. The Central Bank has taken actions to strengthen supervision capacity by completing its stress testing in February 2022.

17. The authorities fully understand that maintaining financial sector stability is crucial to support the economic recovery. They note that the sector has shown resilience during the crisis and is broadly sound. Although the systemwide non-performing loans (NPLs) ratio decreased in 2021, additional measures were introduced to further improve this indicator. In this connection, two new regulations were approved on Asset Classification and Provisions, and Capital Adequacy, primarily requiring banks respectively to (i) update the classification of financial instruments and write off "eligible NPLs" within 12 months; and (ii) maintain adequate levels of own funds, in line with international standards. Regarding the troubled banks, despite the authorities' best efforts, the liquidation process of the three banks is still ongoing, but they are hopeful that meaningful progress will be achieved in 2022.

Structural Reforms

18. The National Sustainable Development Plan 2020-2024, together with the National Strategy for Socioeconomic Resilience and Mitigation of Covid-19, continues to guide the vision for the country's structural transformation aimed at unleashing growth potential, fostering competitiveness, promoting gender inclusiveness, building capacity and infrastructure, and strengthening resilience to shocks. In this respect, the authorities welcome staff's assessment in the Selected Issues Paper (SIP). They broadly agree that addressing the large human capital and infrastructure financing gap is essential to meet the SDGs by 2030. To this end, they see merit in implementing the VAT in 2022 to improve revenue mobilization, complemented by efforts to enhance spending efficiency and foster private investment, will be critical to help close the financing gap. Given the size of the latter, external support is also paramount. To strengthen the financial sector's technological infrastructure and improve financial services to the public, work is underway to expand

access to international payment cards. In addition, the first license was awarded for a fintech for a payment processing business and issuance of e-money, which will contribute to the reduction of the use of paper money and promote the national financial inclusion strategy underway.

19. The authorities share staff's view on the criticality of accelerating reforms of the public utility company EMAE and the energy sector to help increase efficiency, facilitate the transition towards renewable sources as well as ensure public debt sustainability. Although lengthy approval procedures of some development partners may have hindered further progress on the energy sector reform agenda, the authorities remain fully committed to continue implementing the Least Cost Productions Plan and the Management Improvement Plan to achieve cost recovery. In this area, political economy factors should be carefully considered. While committed to the fuel price adjustment mechanism, under the current circumstances of growing social tensions amid rising inflation, floods, electricity shortages, and demand for higher wages, they consider prudent to only implement a partial increase in fuel prices at this stage. Additional price adjustments will be considered in the future while also taking into account the socio-political environment. Targeted social transfers will continue to play an important role in cushioning the impact on the vulnerable groups.

Conclusion

20. The authorities of Sao Tome and Principe reaffirm their commitment to the policy and reform agenda under the ECF-supported program. They are confident that steadfast implementation of their economic program, with the support of development partners, will continue to enhance macroeconomic stability while supporting the recovery and promoting inclusive growth. continues to make progress. They look forward to the Executive Board's completion of the 2022 Article IV consultation and the Fourth Review under the ECF. They also count on the Board's approval of waivers for nonobservance of performance criteria and modification of performance criteria, and financing assurances review.