Statement by Mr. Andrianarivelo Executive Director for the Democratic Republic of São Tomé and Príncipe and Mr. Carvalho da Silveira, Advisor to the Executive Director on Democratic Republic of São Tomé and Príncipe
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Introduction

1. On behalf of the authorities of Sao Tome and Principe (STP), we thank Management and staff for their engagement and unwavering support to STP during these trying times. The authorities broadly agree with staff's assessment of the economy and policy recommendations for the period ahead. Mindful of the challenges going forward, many of which exacerbated by the Covid-19 pandemic, the authorities reaffirm their commitment to the overall program objectives aimed at achieving macroeconomic stability and promoting inclusive growth. Therefore, they request the Executive Board's support for the completion of the second review under the Extended Credit Facility (ECF) and approval of the waiver for nonobservance of performance criterion.

Recent Developments

2. Despite the early success with the first wave of the pandemic, many challenges lie ahead as the country faces a second surge in January 2021. The recent significant spike in the number of Covid-19 daily cases prompted the government to extend the state of calamity for the island of Sao Tome to February 15, 2021. The state of emergency was also reinstated and extended for Principe island to February 20, 2021. These orders were complemented with new prevention and containment measures. As of February 23, 2021, the total cases recorded stood at 1655, of which 1271 recovered and 26 died. The World Bank will support the country's COVID-19 immunization plan and help with the purchase and distribution of vaccines in alignment with the COVID-19 Vaccines Global Access (COVAX) Facility. The first phase of the vaccine rollout will cover 20 percent of the population and is planned to start in April 2021.

3. The authorities expect Real GDP to drop to -6.5 percent in 2020 from 1.3 percent in 2019 due to disruptions in the tourism and service industries, global supply chains as well as delays in externally financed projects. While the 2019 tax package has improved fiscal revenues more than initially foreseen, it was not enough to offset the increase in Covid-19 related spending and wages, which continue to exert considerable pressures on public finances and the already high debt levels. Therefore, the fiscal deficit is expected to increase from 1.8 percent of GDP in 2019 to about 4 percent at year-end 2020. Inflation has also increased to about 10 percent in 2020 and should decline gradually over time. In addition, the current account deficit is anticipated to expand to 17.5 percent in 2020, notably on the back of lower external demand and a drop in remittances. Credit growth to the private sector has also slowed down during the period.

Outlook

4. The economic recovery is underway, but risks abound. In line with staff estimates, the authorities expect real GDP growth to rebound back to 3 percent in 2021 and firm up at around 4.5 percent over the medium-term as tourism activities pick up and infrastructure projects materialize. They are nevertheless aware of risks stemming from delays to vaccination, a more protracted pandemic, and difficulties controlling the new virus outbreak, as well as setbacks to fiscal adjustment and energy sector reforms. Notwithstanding these uncertainties, the authorities have restated their commitment to steadfastly implement the reform agenda envisaged under the program and take additional steps should downside risks materialize.

Performance under the ECF

5. Although overall conditions remain difficult, the implementation of the ECF program progressed in 2020. All end-June 2020 performance criteria (PCs) and Indicative Targets (ITs) were met, except the ones on the domestic primary balance and floor on revenues, mostly due to the fact that they were set prior to the pandemic. Preliminary data indicates that end-December 2020 PCs are firmly on track as the authorities expect to outperform the domestic primary deficit. The authorities recognize that progress on Structural Benchmarks has been somehow limited and emphasize that Covid-19 disruptions and capacity constraints impacted the implementation of the VAT IT system and EMAE reforms. Notwithstanding, they managed to retain fuel prices to support revenue efforts and publish Covid-19 spending reports and public procurement contracts, including the beneficiary ownership information, albeit with delays due to operational challenges. Moreover, the draft of the central bank Organic Law has been completed, pending submission to the Parliament in February 2021, while advances were also made in finalizing the Financial Institutions Law.

Policy Response for 2021 and Beyond

Fiscal Policy

6. The authorities' short-term priority remains to mitigate the social and economic impact of the pandemic, gradually resume fiscal consolidation, and set the stage for a quick recovery without losing sight of medium-term macroeconomic and debt sustainability.

7. Forceful measures have been taken to achieve the 2020 fiscal targets. Preliminary data indicates that the 2020 domestic fiscal deficit (DPD) will reach about 4 percent of GDP, about 2.3 percent lower the program target. This results from strong revenue windfall from tax measures introduced in 2019, most of which are permanent, as well as expenditure rationalization efforts. While maintaining fiscal discipline remained a priority, steps had to be taken to accommodate spending associated with long-overdue promotions for the military and the hiring of health and education personnel to support mitigation efforts. To achieve the

2021 targets, the Parliament approved the 2021 budget with a DPD of 3.9 percent of GDP on January 14th. On the revenue front, the authorities expect revenue to overperform on the back of the solidarity contribution; VAT implementation starting mid-July 2021; and tax policies introduced in 2019 to support domestic revenue mobilization. Fuel price at the pump will remain unaltered to reduce existing fuel subsidy debt. These efforts will be complemented by grants and concessional loans from development partners, including the World Bank (WB), European Union (EU), and African Development Bank (AfDB). On the other hand, control over expenditures will continue to be exercised. Although the authorities remain firmly committed to gradually reduce the wage bill to close to 10% of GDP by 2023, they continue to face mounting social tension from civil servants to raise wages given the severity of the crisis. At the same time, Covid-19 spending will be rolled back when conditions allow. However, in the near-term, this spending is expected to carry on to meet the increased health and education-related demand during the pandemic, albeit with some reallocation. Moreover, pro-poor spending will be maintained in line with the program.

8. Regarding transparency, the government reiterates its commitment to continue to publish information on public procurement contracts and monthly Covid-19 related expenses. They recognize that the absence of an integrated system and other operational constraints to collect and process information have led to delays in publishing contracts. In this regard, technical assistance is being provided by the World Bank to strengthen the management and transparency of the country's procurement system and an executive order has also been issued by the Ministry of Finance, requiring all spending agencies to share contract information with the procurement agency (COSSIL) before the Treasury approves payment.

9. Over the medium-term, actions will be undertaken to (i) forcefully monitor and recover tax payment by large taxpayers; (ii) lower the wage bill by limiting new hiring and halting inflation adjustments; (iii) maintain transfers constant in nominal terms; and (iv) strengthen tax administration and public financial management (PFM) in line with IMF recommendations.

10. The authorities took note of the latest Debt Sustainability Analysis (DSA) which indicates that the external debt is sustainable, in spite of the in-debt distress rating and the deterioration of the country's debt-carrying capacity. They recognize the criticality of accelerating energy sector reforms and continuing fiscal consolidation to preserve debt sustainability. Further, they remain committed to prudent debt management and keep engaging all remaining creditors in an open and transparent manner to regularize arrears and restructure all outstanding debt. They have also requested an extension of the G20 Debt Service Suspension Initiative in light of the continued liquidity pressure.

Monetary and Exchange Rate Policies

11. Effective coordination between fiscal and monetary financial policies remains essential to mitigate the impact of the crisis, boost international reserve buffers and safeguard the peg to the euro. The BCSTP will continue to closely oversee system-wide liquidity to

prevent liquidity tension and stand ready to tight monetary policy to protect the peg. Efforts to enhance the monetary policy framework to improve liquidity management operations are also progressing with the support of the IMF's TA, and a plan is being developed to gradually reduce excess liquidity. Furthermore, to help the coordination between fiscal and monetary authorities, meetings of the Committee for Public Debt have restarted, and work is underway to regularly disseminate the annual schedule of T-Bills issuance, aligned with cash flow forecasts and borrowing plans. The authorities are determined to continue implementing the recommendations of the Safeguard Assessment to improve the independence and transparency of the Central Bank of Sao Tome and Principe. In this connection, the draft of the organic law and the financial institutions law will be submitted to the Parliament in February and March 2020, respectively, to ensure that the country upholds its adherence to international best practices.

Financial Sector

12. The BCSTP has introduced several measures to prevent liquidity strains and ensure the financial sector is resilient in the face of vulnerabilities caused by CovidD-19. In this respect, a credit line was created to support small and medium enterprises (SMEs) in sectors disproportionately affected by the pandemic, with the assistance of the AfDB. Although the banking sector remains relatively well capitalized, asset quality has weakened with the increasing stock of non-performing loans (NPLs). Nonetheless, efforts were made to implement key recommendations of the asset quality review of the banking system, including those related to the loan classification system and recapitalizations.

13. The BCSTP concurs with the need to step up NPLs resolution. To this end, the central bank is expecting to finalize in the coming months a regulation to allow banks to more rapidly and efficiently address write-offs. The judicial loan enforcement process has been strengthened and advances were made to establish an arbitration tribunal for out-of-court settlement by June 2021. Concerning the two failed banks, *Banco Equador* and *Banco Privado*, pandemic-related disruptions have led to delays in their resolution. Therefore, theauthorities plan to relinquish the remaining assets of both banks to the court system in the next few months, particularly if attempts to attract investors are unsuccessful. Furthermore,the central bank has also placed another small bank under temporary administration amid liquidity difficulties caused by the pandemic, until a full evaluation is concluded, and a decision is made regarding the bank's future.

Structural Reforms

14. The authorities acknowledge that continued structural reforms, as envisaged under their National Sustainable Development Plan 2020-2024, are critical to unleash growth potential, improve competitiveness, address impediments to job creation and investments, and strengthen resilience to shocks. Key infrastructure projects are expected to materialize in 2021, including the modernization of the airport, construction of social housing and rehabilitation of 27km of roads. Moreover, solid strides are also being made in upgrading financial sector infrastructure and regulation. In this regard, the legal framework for a

collateral registry is being developed to help SMEs access financing and the new payment system for international credit cards is expected to be operational in February 2021. With the support of development partners, several initiatives are underway to enforce legislations and close gender gaps, improve capacity and resilience to climate change and address inefficiencies in the labor law and judicial system. Work is also ongoing for expediting the plan to remove the country from the European Union's Air Safety blacklist by March 2021.

15. The authorities concur with staff on the high importance of reforming the public utility company EMAE and the energy sector to ensure public debt sustainability, in line with the adopted Least Cost Productions Plans and the Management Improvement Plan. Given the limited progress, they will take decisive steps to implement the necessary reforms to contain fiscal risks. The newly instated steering committee chaired by the Prime Minister will be helpful in this regard.

16. Capacity development from partners has been instrumental in helping the country advance its reform agenda. While they are grateful to the IMF's continued engagement, the Government would like to reiterate their strong interest in the reopening of the resident representative office in Sao Tome to help deepen the engagement and support program implementation.

Conclusion

17. Notwithstanding the daunting policy challenges facing the country, the authorities reiterate their strong commitment to implementing the ECF-supported program. Fund continued engagement will act as an important catalyst for other lenders, while providing an appropriate anchor for reforms aimed at mitigating the impact of the pandemic, safeguarding macroeconomic stability and supporting a quick recovery.

18. In light of the above, the authorities seek the Executive Board's support for the completion of the second review under the ECF and approval of the waiver for nonobservance of performance criterion. They also request a one-year extension of the temporary approval for the retention of measures resulting in exchange restrictions and a multiple currency practice subject to IMF jurisdiction under Article VIII, Sections 2(a) and 3.