

Cape Verde: Second 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 second review under the Policy Support Instrument, the following documents have been released and are included in this package:

- the staff report for the Second Review Under the Policy Support Instrument, prepared by a staff team of the IMF, following discussions that ended on March 16, 2007, 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 April 19, 2007. 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 May 7, 2007 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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CAPE VERDE

Second Review Under the Policy Support Instrument

Prepared by the African Department

(In consultation with other departments)

Approved by David Nellor and Mark Plant

April 19, 2007

- **Fund relations:** The Board concluded the first review of the three-year Policy Support Instrument (PSI) on January 19, 2007. Cape Verde's use of Fund resources stood at SDR 8.64 million (90 percent of quota) on February 28, 2007. Cape Verde has accepted the obligations of Article VIII of the Articles of Agreement and maintains an exchange rate system that is free of restrictions on the making of payments and transfers for current international transactions.
- **The PSI:** Seeks to reduce macroeconomic risks, provide a margin of safety against shocks, and prepare for a possible longer-term decline in access to concessional external financing. Key measures are directed to reducing public debt, building up international reserves, improving public financial management, and strengthening financial sector and energy sector regulation.
- **Currency:** Cape Verde escudo, pegged to the euro since 1999 at a rate of CVEsc 110.3 per €1.
- **Discussions:** March 5–16, 2007. The staff team comprised Mr. MacFarlan (head), Mr. Maehle, Ms. Karpowicz, and Mr. Gons (all AFR). Mr. Sembene of the Executive Director's Office and Ms. Francisco of the World Bank accompanied the mission. The team met with Cristina Duarte, the Minister of Finance and Public Administration; Carlos A. D. De Burgo, the Governor of the Bank of Cape Verde; other officials; the Finance and Budget Committee of the National Assembly; and representatives of commercial banks, the energy sector, and trade unions.
- **Publication:** The authorities have agreed to publish this staff report and the Letter of Intent.

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EXECUTIVE SUMMARY

Economic and policy performance remains strong. Growth estimates and projections have been revised upward, partly because of high and rising foreign direct investment inflows; inflation and unemployment are falling; and the key program objective of reducing macroeconomic risks, particularly through lowering public debt and increasing official foreign exchange reserves, is being met.

Macroeconomic policies are on track to meet or surpass program targets. Reserve accumulation is substantially above program goals and the end-2007 domestic debt-to-GDP ratio is expected to be significantly lower than targeted.

Structural reforms are moving ahead. Progress is being made on improving budget management and audit processes; preventing public sector arrears; reforming tax laws and administration; and strengthening regulatory frameworks for the energy and financial sectors.

Two quantitative assessment criteria were missed. Domestic borrowing increased unexpectedly in late 2006 because of delayed proceeds from land sales and privatization together with lower-than-expected profit transfers from public enterprises. This increase will be unwound in 2007 as the delayed revenues arrive. There was also some further accumulation of domestic arrears in late 2006 while new procedure to prevent arrears, as agreed during discussions for the first review in November, were being implemented. Because of the firm corrective actions being taken in both cases, the staff recommends granting waivers.

Uncertainties and risks remain. Among them are the possible withdrawal of emigrant deposits as interest rate differentials over foreign rates narrow; and the need for large-scale investment and financing to enable energy sector and infrastructure growth to keep pace with economic development. Measures being implemented to address these risks include a strengthening of the monetary policy framework and a comprehensive review of the energy sector. The ambitious fiscal and monetary targets could become more difficult to attain if sales of government land are further delayed or if large foreign exchange inflows lead to a stronger-than-expected surge in imports.

I. INTRODUCTION

1. **Cape Verde's economic program under the Policy Support Instrument (PSI) is designed to help the country prepare for the opportunities and challenges associated with its graduation from UN least-developed-country (LDC) status in 2008.** The program emphasizes reducing macroeconomic risks, increasing the margin of protection against shocks, and preparing for a possible longer-term decline in access to concessional external financing. The main objectives are to increase foreign reserves, reduce domestic debt, and create fiscal space to meet spending priorities.

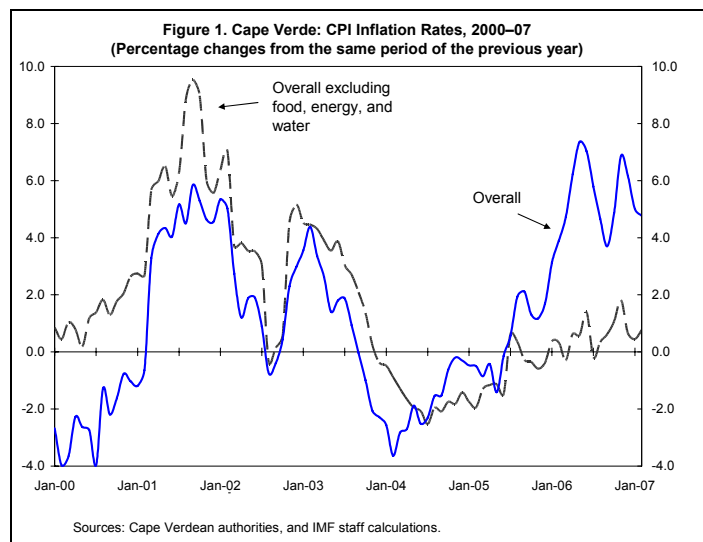
2. **To further the macroeconomic agenda, discussions during the second review addressed structural measures the authorities are implementing or planning to reinforce:**

- **Public sector management**, especially by improving budget implementation and control, preventing arrears, strengthening debt management, and raising civil service productivity.
- **The monetary and financial system**, particularly the operating framework for monetary policy and financial sector supervision and regulation, including in the offshore center.
- **Energy sector regulation**, notably the mechanisms to set electricity and water tariffs and adjust retail petroleum prices.

II. RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE PSI

3. **Cape Verde's economic and policy performance is strong.** Based on the strength of recent indicators—including consumption and investment demand, business confidence, and tourism exports—the GDP growth estimate for 2006 has been revised up from 5.8 to 6.5 percent. Unemployment fell to 18.3 percent in 2006, down 6.1 percentage points from 2005.

4. **Though consumer inflation rose in late 2006 after a court ruling required a change in the way value-added tax (VAT) was applied to certain price-controlled products, it is now falling** (Figure 1). The court declared unconstitutional government decrees that had altered the base upon which VAT was charged for electricity, water, transportation, and other services deemed essential. As a result, prices for some items rose significantly. The previous tax

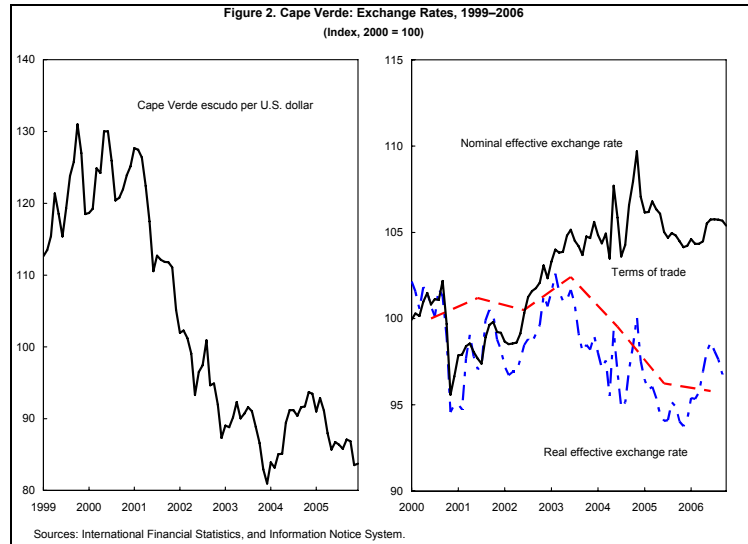


structure was largely restored in the 2007 Budget Law. These swings in headline inflation are reflected in the real effective exchange rate (Figure 2).

5. **Monetary policy in 2006 was consistent with the program goal of building up foreign exchange reserves to support the exchange rate peg.** Reserve accumulation reached 3.0 months of prospective imports at the end of 2006 (Figure 3)—above the program target. Cape Verde has continued to attract inflows of official assistance, and tourism exports and foreign direct investment (FDI) have picked up strongly.

Net inflows of remittances and emigrant deposits also continued, even though the spread of the emigrant deposit rate against the euro area rate has narrowed substantially in recent years (Figure 4).¹

Excess reserves of commercial banks declined toward the end of 2006 as the BCV's sterilization efforts and continued growth in private



sector credit gradually drained excess liquidity (Figure 5). The largest share of the credit growth went to highly collateralized lending for real estate and a domestic bank's purchase of a Portuguese bank's claim of €71 million on Electra (the electricity and water company);² the latter transaction also lowered the record-high net foreign assets of commercial banks—a reflection of the excess liquidity.

6. **Fiscal policy in 2006 was largely consistent with program goals.** Tax revenues were higher than projected and recurrent public spending was firmly restrained. A record-high execution rate of the public investment program was reported. Toward the end of the year, domestic borrowing increased unexpectedly because of delayed proceeds from land sales and privatization and unexpectedly low profit transfers from public enterprises. As a result, the program ceiling on net domestic borrowing was exceeded by 0.8 percent of GDP (after adjustors were applied). Nevertheless, helped by unexpectedly high growth in nominal GDP, the net domestic debt-to-GDP-ratio was reduced sharply—from 33.5 percent of GDP at the end of 2005 to 28.7 percent at the end of 2006 (close to the initial program target; Figure 3).

¹ The average emigrant time deposit rate at end-2006 was 4.4 percent, 1.5 percent above the euro area rate.

² The claim was bought for a present value of €38 million and has since been restructured; part has been securitized and will be offered on the local stock market.

Figure 3. Cape Verde: Selected Macroeconomic Indicators, 1995–2006
(Percent of GDP, unless otherwise indicated)

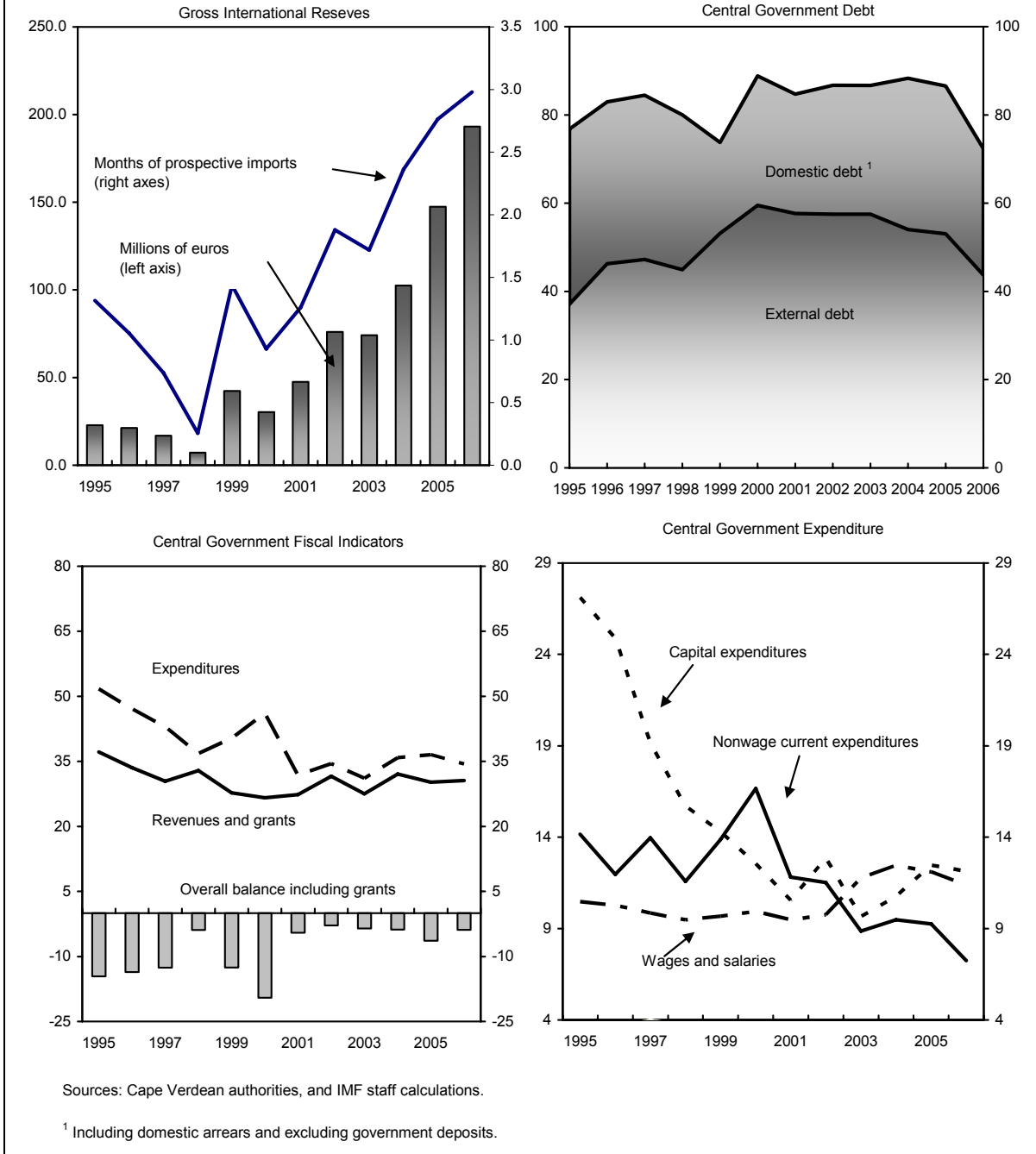
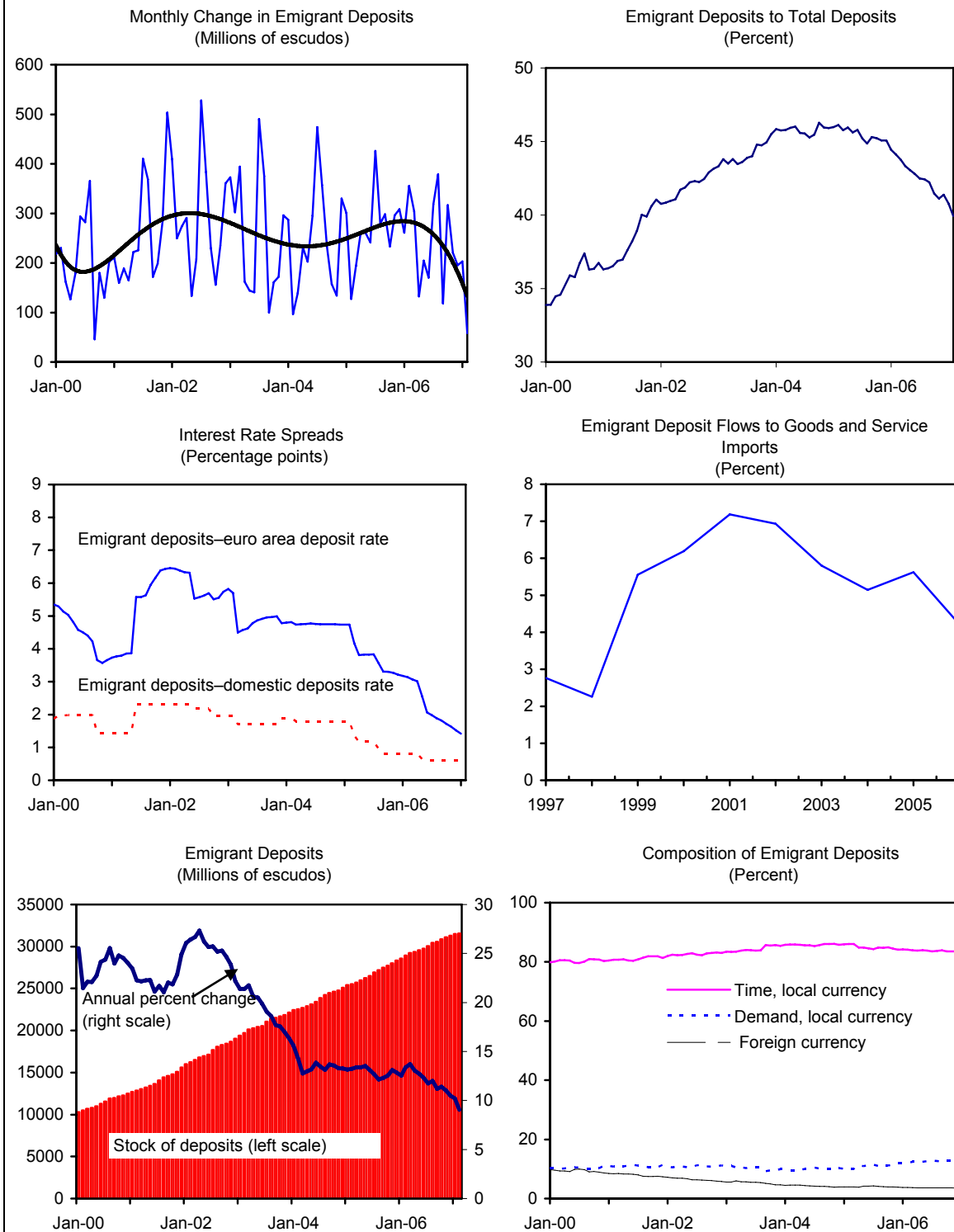


Figure 4. Cape Verde: Emigrant Deposits, 2000–07



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

7. **The Ministry of Finance is making progress in tackling domestic arrears.** The stock of arrears is being cleared more rapidly than initially targeted. The government is also implementing measures agreed during the first program review to avoid accumulating new arrears. In particular, the Ministry is:

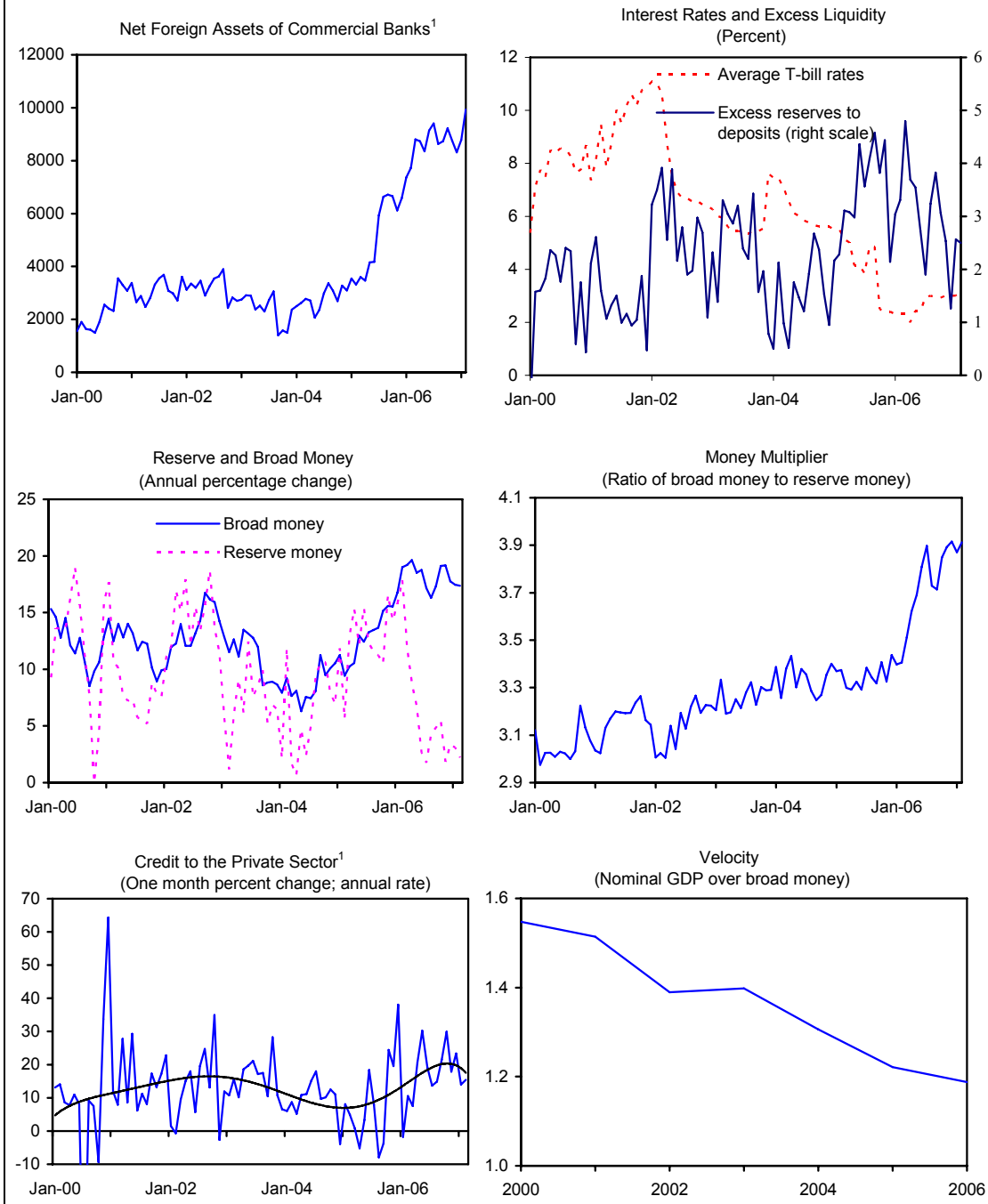
- more carefully monitoring the payment arrears of central government entities, including semi-autonomous agencies;
- working with these entities to strengthen their budget execution and payment practices; and
- putting in place procedures to make the required payments on behalf of these entities if they continue to incur arrears and deduct those amounts from government transfers to them.

In addition:

- Municipalities have signed a memorandum of understanding accepting their responsibility to pay electricity bills on time and have begun to comply with this agreement; and
- The government plans to introduce a tax on consumer electricity bills to meet the costs of public lighting, which has been a persistent area of dispute between municipalities and Electra.

In November-December 2006, however, while these new procedures were being implemented, hospitals again incurred arrears to the state-owned pharmaceutical company. Also, arrears to Electra that accumulated earlier in 2006 were not fully unwound by the end of the year.

Figure 5. Cape Verde: Selected Monetary Indicators, 2000–07
 (Millions of escudos, unless otherwise specified)



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

1. Excluding a domestic bank's purchase of a Portuguese credit to Electra.

8. **There has also been notable progress with other structural reforms:**

- The automatic adjustment mechanism for electricity and water tariffs was published in January 2007 and is being applied.
- A draft public employment law will soon be submitted to the National Assembly. It will provide the legal base for new salary plans and career and mobility rules for public administration.
- A Large Taxpayers Unit has been established in the Ministry of Finance and will be fully operational by mid-2007.
- A new law concerning the Court of Auditors (TdC) has been submitted to the National Assembly, and the Inspectorate General of Finance has been reinforced with additional staff and brought within a new organic law.
- The public sale of most of the government's remaining shares in Enacol, a petroleum distribution company, has been initiated through the Cape Verde Stock Exchange—the biggest financial operation ever in Cape Verde.

III. REPORT ON THE DISCUSSIONS

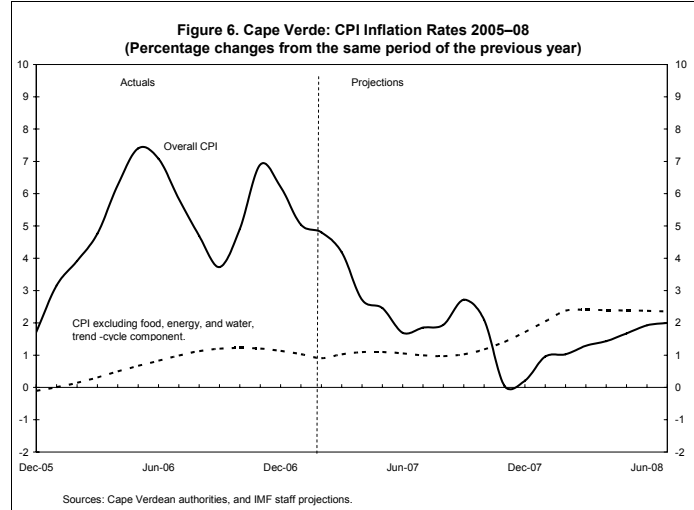
9. **In its Letter of Intent (LOI; Appendix I), the government reaffirms its commitment to the macroeconomic and structural objectives of the PSI program.** Policy discussions focused on updating the macroeconomic framework and on structural measures to improve fiscal and monetary management, and energy and financial sector regulation.

A. Macroeconomic Framework

10. **The macroeconomic framework is largely unchanged since the first review:**

- **Growth:** The projection for 2007 was revised up to 6.9 percent, reflecting significant increases in FDI that are in the pipeline. Medium-term growth is expected to average above 7 percent, driven primarily by the FDI-led expansion of the tourism industry.

- Inflation:** The 12-month rate is expected to return to low single digits during 2007 as fresh food prices continue declining toward trend levels (Figure 6).³ The current growth in private sector credit is expected to have limited impact on inflation. Since most of the consumer basket comprises imported products, and the small domestic component is dominated by fresh food, inflation in Cape Verde seems to be predominantly a supply-side phenomenon; demand growth leads mainly to increased imports.



- International reserves:** The target of increasing reserves by at least another 0.1 month of prospective imports in 2007 was retained.
- Domestic debt repayment:** Using the delayed proceeds from privatization and land sales, now expected to arrive in 2007, this year's repayment target was raised by CVEsc 800 million to unwind the higher-than-expected borrowing in 2006. The domestic-debt-to-GDP ratio is expected to decline to 22.5 percent by year-end.

B. Monetary Conditions and Prospects

11. **The BCV is more actively managing liquidity.** Since December 2006 it has aimed to fully sterilize the liquidity impact of reserve accumulation by issuing 14-day and 6-month central bank bills. The BCV is continuing to explore a formal operating framework based on closer monitoring and targeting of external interest rate differentials. In an attempt to create an official policy rate, the BCV has been offering 14-day bills at a fixed interest rate, currently set at a margin below the Euribor rate. Through this approach, the BCV has aimed to reduce commercial bank incentives for placing excess liquidity abroad while recognizing

³ These projections are based on the current CPI. The National Statistical Institute will soon release a new CPI that may be less susceptible to large swings in prices of a few domestically-produced food items. The possible impact of increased tourism demand for these items adds further uncertainty to the inflation outlook.

the transactions costs of these overseas placements.⁴ The BCV is seeking further technical assistance to support their efforts to strengthen monetary operations.

12. **Following discussions with the BCV and commercial banks, the staff agreed that excess liquidity in the banking system has eased in recent months**, mainly because of increased sterilization efforts and continued rapid growth in private sector credit. These developments have also reduced the downward pressure on emigrant deposit rates. Banks are seeing both requests for withdrawals from some emigrants and increased domestic competition for these deposits.⁵ Furthermore, increased private sector access to international capital markets and to the offshore financial institutions has exacerbated the interest rate pressures and market distortions caused by the high reserve requirement. Responding to these concerns, the BCV lowered the reserve requirement from 15 to 14 percent in late March 2007 and intends, if necessary, to fully sterilize the liquidity increase.

C. Structural Fiscal Issues

13. **In the LOI the government commits to improving public sector financial management; it plans to**

- Submit to the National Assembly legislation to support streamlining of tax exemptions, a revised General Tax Code, a new Code on Judicial Processes, and bills on individual and corporate income taxes. While the tax exemption reforms are slightly delayed from end-June to end-December 2007, the government is determined to implement measures to rationalize exemptions, in coordination with its other tax reform initiatives.
- Reform the structure and functions of the Tax Directorate in the Ministry of Finance.
- Set up a new customs audit court and modernize the Inspectorate General of Finance.
- Improve budget management—e.g., by better forecasting revenue and financing flows, broadening coverage of the medium-term expenditure framework, and expanding the online, real-time system (SIGOF) for budget execution and monitoring.
- Prevent arrears by fully implementing the measures agreed in 2006 (see ¶7). Indications from the authorities are that these measures are now taking hold.

⁴ The supply of 14-day bills offered in each tender is not predetermined. The 6-month bills are auctioned in a fixed-amount variable-rate tender.

⁵ Banks still offer a small interest premium (e.g., 25 basis points) on some emigrant deposits, mainly for historical reasons; the size and significance of this premium has been declining, however, and on some deposits no premium is paid.

LEG is providing technical assistance on tax legislation, and the authorities have requested further technical assistance from FAD to help them formulate criteria for granting tax exemptions.

D. Financial Sector

14. **The BCV is moving ahead with plans for strengthening regulation of the financial sector, including the growing offshore financial center.** A consultant has completed a report assessing the legal and institutional framework and, after discussions with stakeholders, the BCV expects to finalize legislative proposals by December 2007. Discussions are well advanced on information-sharing agreements with home country supervisors of institutions operating in Cape Verde, although formal agreements have not yet been signed. An AML/CFT assessment mission from the IMF is planned for the second quarter of 2007. To safeguard Cape Verde's good reputation, staff reiterated the need for caution in granting offshore licenses until the regulatory environment is consistent with international standards.

E. Public Investment and Financing

15. **Staff recommended, and the authorities agreed, that a comprehensive medium-term investment plan be prepared, including for state-owned enterprises.** This approach would support prioritization of public investment and the planning needed to secure concessional external financing. It would also help identify the possible financing gap to be met by fiscal measures or, if debt sustainability considerations allow, through less-concessional government and government-guaranteed external borrowing. This approach should also enable the program ceiling on external nonconcessional borrowing to be set on a more systematic basis.⁶

F. Automatic Price Adjustment Mechanisms

16. **The government is improving the regulatory framework for the energy sector.** With the automatic adjustment mechanism for electricity and water tariffs now in place, the Economic Regulatory Agency (ARE) expects to finalize a mechanism for setting base tariffs by mid-2007. ARE also intends to apply the current adjustment mechanism for retail petroleum prices soon after each incoming shipment of petroleum products, as originally envisaged. Further, the government has embarked on a comprehensive review of the structure, operation, and regulation of the energy sector. The staff emphasized that automatic and transparent updates of utility tariffs and petroleum prices would depoliticize price setting, safeguard the budget, and give companies incentives for investment and efficiency gains.

⁶ This ceiling was only partially used in 2006, for infrastructure projects; for 2007, nonconcessional loan guarantees may be used for port, airport, and electricity sector development.

IV. PROGRAM MONITORING

17. **Assessment criteria, benchmarks, and indicative targets for the next two reviews are in Tables A1 and A2 of the LOI.** The review schedule is in Table 8.

V. STAFF APPRAISAL

18. **Cape Verde continues to display commendable economic and policy performance.** Growth estimates and projections have been revised upward; inflation and unemployment are falling; and the program objective of reducing macroeconomic risks is being met. In particular, progress is being made in reducing public debt, building up official foreign exchange reserves, improving fiscal and monetary management, and strengthening energy and financial sector regulation.

19. **Fiscal and monetary policies are on track to meet or surpass program goals.** Reserve accumulation in 2006 substantially exceeded the target and the domestic debt-to-GDP ratio has been substantially reduced. Though borrowing in 2006 was higher than expected, this increase is set to be unwound in 2007 and domestic debt at year-end is likely to be significantly lower than originally targeted.

20. **The government is making progress in clearing arrears and preventing further arrears.** To put an end to this persistent problem, the procedures agreed during the first program review for stopping arrears accumulation need to be firmly implemented, including among semi-autonomous public entities.

21. **The government is also taking important steps to improve the regulatory framework for the energy sector.** Automatic and transparent adjustment of utility tariffs and petroleum prices should help depoliticize price-setting, safeguard the government budget, and provide incentives for investment and efficiency gains.

22. **A comprehensive medium-term investment plan for government and state-owned enterprises** should help the authorities to prioritize public investment, identify concessional financing, and set the external nonconcessional borrowing ceiling more systematically, subject to debt sustainability constraints. This approach should be supported by further strengthening of debt management and accounting, backed by technical assistance.

23. **The authorities should move rapidly to strengthen regulation of the financial sector, especially the offshore center.** This is needed to cope with reputational risks and other challenges posed by rapid development of the financial system and increased interaction between the offshore center and the domestic economy. Caution is needed in granting offshore licenses until these reforms are implemented.

24. **Staff recommends completion of the second program review.** Based on the strength of the authorities' policies and the corrective measures being taken, staff supports granting waivers for the two December 2006 assessment criteria—on domestic borrowing and arrears accumulation—that were missed.

Table 1. Cape Verde: Selected Economic and Financial Indicators, 2005–09

	2005	2006		2007	2008	2009
		Program	Prel.		Projections	
	(Annual percentage change)					
National accounts and prices						
Real GDP	5.8	5.5	6.5	6.9	7.5	7.8
Real GDP per capita	3.8	3.5	4.5	4.9	5.5	5.7
Consumer price index (annual average)	0.4	6.2	5.4	2.5	1.8	1.9
Consumer price index (end of period)	1.7	5.5	6.2	0.2	2.2	1.8
External sector						
Exports of goods and services	23.9	8.9	29.6	19.5	16.4	16.0
Imports of goods and services	0.5	14.6	23.1	21.6	17.3	13.8
Real effective exchange rate (annual average)	-2.3	...	-0.2	...	...	...
Terms of trade (minus = deterioration)	-5.6	-0.5	-6.3	3.0	2.0	2.7
Government budget						
Total revenue (excluding grants)	11.3	17.3	19.6	18.3	10.9	10.7
Total expenditure	10.1	27.8	7.7	16.6	7.9	8.6
Noncapital expenditure	3.7	20.7	5.7	13.4	12.7	9.5
Capital expenditure	25.2	40.1	11.4	22.4	-0.2	6.8
Money and credit						
Net foreign assets	58.8	19.0	14.8	33.6	15.3	14.6
Net domestic assets	3.4	11.2	19.0	8.9	10.2	10.9
Of which: net claims on the central government credit to the economy ¹	0.9	6.9	1.2	-9.6	-3.0	1.5
Broad money (M2)	9.0	13.7	17.3	15.3	13.8	13.1
Domestic broad money (M2X)	15.5	13.6	17.7	16.1	11.9	12.2
Income velocity (GDP/M2)	17.3	15.4	22.4	16.1	11.9	12.2
Income velocity (GDP/M2)	1.31	1.27	1.28	1.25	1.22	1.21
	(Percent of GDP)					
Saving-investment balance						
Gross capital formation	37.3	38.7	39.2	44.4	49.3	52.9
Government	8.9	14.4	8.7	9.8	10.1	9.7
Nongovernment	28.3	24.2	30.5	34.6	39.3	43.2
Gross national savings	33.9	31.8	32.8	32.1	32.7	36.3
Of which: government	6.3	9.0	9.7	8.2	8.1	8.2
External current account (including official current transfers)	-3.4	-6.9	-6.4	-12.2	-16.6	-16.7
Government budget						
Total revenue	23.8	25.1	24.9	25.8	25.8	25.7
Total grants	6.4	9.0	5.7	6.1	5.3	5.4
Total expenditure	36.6	41.2	34.4	35.1	34.2	33.4
Overall balance before grants	-12.8	-16.1	-9.5	-9.3	-8.4	-7.7
Overall balance (including grants)	-6.4	-7.1	-3.8	-3.2	-3.1	-2.3
External financing (net)	3.1	3.5	3.1	2.6	2.4	1.6
Domestic financing (net)	0.8	3.6	1.7	0.6	0.7	0.6
Financing gap/ statistical discrepancy	2.4	0.0	-1.0	0.0	0.0	0.0
Total nominal government debt ²	86.6	80.8	72.4	63.5	58.7	53.5
External government debt ³	53.1	52.4	43.7	41.0	39.2	36.7
Domestic government debt, net of deposits	33.5	28.4 ⁴	28.7	22.5	19.5	16.8
External current account (excluding official current transfers)	-8.0	-14.4	-10.6	-15.9	-19.2	-19.2
Overall balance of payments	5.6	2.2	5.2	4.0	3.5	3.9
External current account (millions of euros, including official transfers)	-27.3	-61.0	-58.6	-128.7	-193.9	-216.1
Gross international reserves (millions of euros, end of period)	147.4	166.4	193.1	234.2	275.1	325.4
Gross international reserves (months of prospective imports of goods and services)	2.8	3.1	3.0	3.1	3.2	3.3
External debt service (percent of exports of goods and services)	8.6	8.2	5.9	5.1	5.7	5.8
<i>Memorandum items:</i>						
Nominal GDP (billions of Cape Verde escudos)	88.7	98.1	101.6	116.0	128.6	143.0
Exchange rate (Cape Verde escudos per U.S. dollar)						
Period average	88.7	...	87.8	...	...	...
End period	93.5	...	83.5	...	...	...

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

¹ Excluding a December 2006 purchase of a Portuguese credit to Electra.

² Net of central government deposits; including verified stock of domestic and external arrears.

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, 2005-09

(Millions of Cape Verde escudos, unless otherwise indicated)

	2005	2006		2007		2008	2009
	Prel.	Program	Prel.	Budget	Proj.	Projection	
Revenue, grants, and net lending	26,779	33,437	31,044	35,295	36,964	39,950	44,459
Domestic revenue (incl. net lending)	21,123	24,604	25,255	26,963	29,871	33,138	36,699
Tax revenue	18,601	21,099	22,828	24,178	26,599	29,524	32,764
Income and profit taxes	5,822	6,955	6,952	7,497	8,109	9,096	10,255
Consumption taxes	7,390	8,351	9,821	10,140	11,285	12,579	14,060
International trade taxes	4,231	4,501	4,889	5,458	5,839	6,307	6,889
Other taxes	1,158	1,291	1,166	1,083	1,366	1,542	1,560
Nontax revenue	2,375	3,505	2,017	2,585	3,021	3,413	3,784
Net lending	147	0	301	200	251	201	151
External grants	5,657	8,833	5,789	8,332	7,093	6,812	7,760
Capital grants	5,106	7,003	4,035	6,706	5,365	6,205	7,025
Budget support	551	1,830	1,755	1,625	1,728	606	736
Total expenditure	32,437	40,413	34,924	39,943	40,712	43,933	47,698
Recurrent expenditure	18,948	22,416	18,908	22,575	23,904	25,079	27,583
Primary recurrent expenditure	17,018	20,593	16,988	20,692	22,021	23,037	25,417
Wages and salaries	10,733	12,712	11,547	13,165	13,165	14,603	16,068
Goods and services	1,157	1,862	1,197	2,127	2,127	2,338	2,596
Transfers and subsidies	3,149	5,146	3,464	3,869	5,198	4,422	4,911
Transfers	2,616	3,921	3,172	3,834	3,927	4,316	4,793
Subsidies	533	1,225	292	35	1,271	106	118
Of which: petrol price subsidies	450	1,200	208	0	1,165	0	0
Other expenditures	1,979	873	781	1,531	1,531	1,675	1,843
Domestic interest payments	1,384	1,300	1,398	1,352	1,352	1,321	1,331
External interest payments	546	522	522	531	531	721	835
Extraordinary expenditures	0	0	0	0	0	0	0
Capital expenditure	11,073	16,290	12,338	16,340	15,102	15,065	16,089
Foreign financed	9,204	12,534	11,096	13,487	12,249	11,626	11,841
Domestically financed	1,869	3,755	1,242	2,853	2,853	3,439	4,248
Other expenditures (incl. arrears clearance)	2,416	1,708	3,678	1,028	1,707	3,789	4,027
Overall balance, including grants (budget basis)	-5,657	-6,976	-3,880	-4,648	-3,748	-3,983	-3,239
Financing	5,657	6,976	3,880	4,648	3,748	3,983	3,239
Foreign (net)	2,785	3,414	3,130	3,043	3,043	3,084	2,340
Domestic financing (net)	713	3,575	1,759	1,605	706	900	900
Net domestic borrowing	713	830	1,639	-602	-1,402	300	300
Banking system	141	989	186	...	-1,472	-412	206
Nonbanks	572	-158	1,454	...	71	712	94
Privatization and other sales of assets	816	3,689	459	2,207	2,755	600	600
Accounts payable (late payments or <i>atrasados</i>), net	30	-944	-339	...	-647	0	0
Net errors and omissions	2,160	0	-1,010	0	0	0	0
<i>Memorandum items:</i>							
Overall balance, including grants (excluding clearance of arrears and net late payments)	-4,258	-4,324	-1,529	-3,620	-2,073	-2,676	-1,932
Arrears clearance (part of <i>despesa extraordinária</i> and other)	1,430	1,708	2,012	1,028	1,028	1,307	1,307
Domestic borrowing, excluding for clearance of arrears and net late payments	-686	-1,821	-712	-1,630	-3,077	-1,007	-1,007
Primary balance (including grants) ¹	-3,728	-5,154	-1,960	-2,765	-1,865	-1,941	-1,074
Recurrent domestic balance ²	2,175	2,188	6,347	4,389	5,967	8,059	9,116
Net external flows ³	8,441	12,234	8,919	11,375	10,135	9,895	10,099
External debt service (percent of domestic revenue)	12.3	10.7	9.9	9.8	8.8	10.1	10.8
Domestic debt (including arrears and accounts payable, net of deposits) ⁴	29,723	27,902	29,134	25,426	26,057	25,050	24,043

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 1,206 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, 2005-09

(Percent of GDP)

	2005	2006		2007		2008	2009
	Prel.	Program	Prel.	Budget	Proj.	Projection	
Revenue, grants, and net lending	30.2	34.1	30.4	30.4	31.9	31.1	31.1
Domestic revenue (incl. net lending)	23.8	25.1	24.7	23.3	25.8	25.8	25.7
Tax revenue	21.0	21.5	22.5	20.8	22.9	23.0	22.9
Income and profit taxes	6.6	7.1	6.8	6.5	7.0	7.1	7.2
Consumption taxes	8.3	8.5	9.7	8.7	9.7	9.8	9.8
International trade taxes	4.8	4.6	4.8	4.7	5.0	4.9	4.8
Other taxes	1.3	1.3	1.1	0.9	1.2	1.2	1.1
Nontax revenue	2.7	3.6	2.0	2.2	2.6	2.7	2.6
Net lending	0.2	0.0	0.3	0.2	0.2	0.2	0.1
External grants	6.4	9.0	5.7	7.2	6.1	5.3	5.4
Capital grants	5.8	7.1	4.0	5.8	4.6	4.8	4.9
Budget support	0.6	1.9	1.7	1.4	1.5	0.5	0.5
Total expenditure	36.6	41.2	34.4	34.4	35.1	34.2	33.4
Recurrent expenditure	21.4	22.8	18.6	19.5	20.6	19.5	19.3
Primary recurrent expenditure	19.2	21.0	16.7	17.8	19.0	17.9	17.8
Wages and salaries	12.1	13.0	11.4	11.4	11.4	11.4	11.2
Goods and services	1.3	1.9	1.2	1.8	1.8	1.8	1.8
Transfers and subsidies	3.5	5.2	3.4	3.3	4.5	3.4	3.4
Other expenditures	2.2	0.9	0.8	1.3	1.3	1.3	1.3
Domestic interest payments	1.6	1.3	1.4	1.2	1.2	1.0	0.9
External interest payments	0.6	0.5	0.5	0.5	0.5	0.6	0.6
Extraordinary expenditures	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capital expenditure	12.5	16.6	12.1	14.1	13.0	11.7	11.3
Foreign financed	10.4	12.8	10.9	11.6	10.6	9.0	8.3
Domestically financed	2.1	3.8	1.2	2.5	2.5	2.7	3.0
Other expenditures (incl. arrears clearance)	2.7	1.7	3.6	0.9	1.5	2.9	2.8
Overall balance, including grants (budget basis)	-6.4	-7.1	-3.9	-4.0	-3.2	-3.1	-2.3
Financing	6.4	7.1	3.8	4.0	3.2	3.1	2.3
Foreign (net)	3.1	3.5	3.1	2.6	2.6	2.4	1.6
Total drawings	5.4	5.6	5.0	4.4	4.4	4.5	3.8
Amortization	-2.3	-2.2	-1.9	-1.8	-1.8	-2.1	-2.2
Domestic financing (net)	0.8	3.6	1.7	1.4	0.6	0.7	0.6
Net domestic borrowing	0.8	0.8	1.6	-0.5	-1.2	0.2	0.2
Banking system	0.2		0.2	-0.5	-1.3	-0.3	0.1
Nonbanks	0.6		1.4	0.0	0.1	0.6	0.1
Privatization and other sales of assets	0.9	1.4	0.5	1.9	2.4	0.5	0.4
Accounts payable (late payments or <i>atrasados</i>), net	0.0	2.3	-0.3	0.0	-0.6	0.0	0.0
Net errors and omissions	2.4	0.0	-1.0	0.0	0.0	0.0	0.0
Financing gap	0.0	0.0	...	0.0	0.0	0.0	0.0
<i>Memorandum items:</i>							
Overall balance, including grants (excluding clearance of arrears and net late payments)	-4.8	-4.4	-1.5	-2.6	-1.8	-2.1	-1.4
Arrears clearance (part of <i>despesa extraordinária</i> and other)	1.6	1.7	2.0	0.9	0.9	1.0	0.9
Domestic borrowing excluding for clearance of arrears and net late payments	-0.8	-1.9	-0.7	-2.0	-2.7	-0.8	-0.7
Primary balance (including grants) ¹	-4.2	-5.3	-1.9	-2.4	-1.6	-1.5	-0.8
Recurrent domestic balance ²	2.5	2.2	6.2	3.8	5.1	6.3	6.4
Net external flows ³	9.5	12.5	8.8	8.4	8.7	7.7	7.1
Domestic debt (including arrears and accounts payable, net of deposits)	33.5	28.4	28.7	22.5	22.5	19.5	16.8

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	-6,463	-14,194	-21,382	-23,833
Trade balance	-30,960	-37,178	-41,717	-54,041	-65,238	-75,416
Exports, f.o.b.	7,891	8,862	7,366	6,783	7,256	7,584
Imports, f.o.b.	-38,851	-46,040	-49,082	-60,824	-72,495	-83,000
Services (net)	6,148	5,782	13,327	18,658	23,256	28,919
Credit	24,667	25,513	34,842	43,652	51,433	60,469
Of which: tourism	10,466	10,327	18,377	25,143	31,843	39,488
Debit	-18,519	-19,731	-21,515	-24,994	-28,177	-31,550
Income (net)	-2,984	-2,905	-3,943	-4,870	-5,646	-6,168
Credit	1,641	2,167	1,627	2,094	2,377	2,633
Debit	-4,625	-5,073	-5,570	-6,964	-8,024	-8,800
Government interest	-551	-713	-522	-531	-721	-835
Interest by other sectors	-3,040	-3,587	-2,440	-2,893	-2,978	-3,049
Income on direct investment and other income	-1,034	-773	-2,608	-3,540	-4,325	-4,916
Current transfers (net)	24,780	27,577	25,869	26,059	26,246	28,832
Government	4,090	7,404	4,310	4,269	3,260	3,604
Other	20,690	20,173	21,559	21,789	22,986	25,228
Capital and financial account (net)	7,031	8,900	12,249	18,778	25,846	29,423
Capital transfers	1,821	1,420	2,383	2,826	3,552	4,157
Government	1,831	1,420	2,383	2,826	3,552	4,157
Of which: MCA	665	333	659	1,250	1,804	2,213
Other	200	0	0	0	0	0
Direct investment (net)	6,696	2,110	10,710	15,587	18,121	21,008
Portfolio investment	0	0	25	25	25	25
Government	1,880	3,431	2,266	3,090	3,084	2,340
Trust Fund	-200	0	0	0	0	0
Net official flows	2,080	3,431	2,266	3,090	3,084	2,340
Disbursements	4,314	5,531	4,240	5,156	5,726	5,457
Amortization	-2,234	-2,101	-1,974	-2,066	-2,642	-3,116
Other	0	0	0	0	0	0
Other capital	-3,366	1,939	-3,136	-2,749	1,064	1,893
Commercial banks	-4,883	-2,071	-3,041	-3,895	-560	17
Commercial credit (net)	564	0	189	0	0	0
Other	953	4,011	-284	1,145	1,624	1,876
Net errors and omissions	986	0	-511	0	0	0
Overall balance	5,000	2,175	5,274	4,584	4,463	5,589
Financing	-5,000	-2,096	-5,274	-4,526	-4,515	-5,548
Gross international reserves (– accumulation)	-4,964	-2,096	-5,043	-4,526	-4,515	-5,548
Of which: IMF (net)	380	0	-63	-15	-64	-126
Exceptional financing	-36	0	-231	0	0	0
Financing gap	0	-80	0	-58	52	-41
<i>Memorandum items:</i>						
Current account (including official transfers)	-3.4	-6.9	-6.4	-12.2	-16.6	-16.7
Current account (excluding official transfers)	-8.0	-14.4	-10.6	-15.9	-19.2	-19.2
Overall balance	5.6	2.2	5.2	4.0	3.5	3.9
Gross international reserves	16,260	18,356	21,304	25,830	30,345	35,894
Months of current year's import of goods and services	3.4	3.3	3.6	3.6	3.6	3.8
Months of next year's import of goods and services	2.8	3.1	3.0	3.1	3.2	3.3
External public debt	47,099	51,456	44,414	47,504	50,478	52,565
Including financing gap	47,099	51,456	44,414	47,447	50,472	52,518
External aid (grants and loans; percent of GDP)	11.5	14.6	10.8	10.6	9.7	9.2

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	Actual		Projections	
	(Millions of Cape Verde escudos, unless otherwise specified)					
Net foreign assets	21,889	26,056	25,137	33,573	38,712	44,369
<i>Of which:</i> excluding the effect of a purchase of a Portuguese credit to Electra						
Foreign assets	21,889	26,056	29,531	...	...	...
<i>Of which:</i> foreign reserves	27,549	31,716	31,285	39,855	45,034	50,671
Foreign liabilities	16,260	18,356	21,304	25,830	30,345	35,894
	-5,660	-5,660	-6,147	-6,283	-6,322	-6,302
Net domestic assets	50,755	56,456	60,398	65,763	72,441	80,341
Net domestic credit	60,193	65,127	70,487	75,895	82,615	90,559
Net claims on general government	25,697	25,854	25,632	24,159	23,747	23,953
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	15,392	13,920	13,508	13,714
Credit to central government	20,044	21,033	19,470	17,894	17,382	17,494
Deposits of central government	-4,837	-5,626	-4,078	-3,974	-3,874	-3,780
<i>Of which:</i> project deposits	-351	-277	-716	-277	-277	-277
Net claims on local government	21	-22	-311	-311	-312	-312
Net claims on other government agencies (INPS)	-569	-569	-488	-488	-488	-488
Credit to the economy	34,496	39,273	44,855	51,736	58,868	66,606
<i>Of which:</i> excluding purchase of a Portuguese credit to Electra						
Credit to public enterprises	431	497	634	678	703	736
Credit to private sector	34,040	38,751	44,205	51,042	58,150	65,854
Claims on nonbank financial institutions	26	26	16	16	16	16
Other items (net)	-9,438	-8,671	-10,089	-10,133	-10,175	-10,218
Broad money (M2)	72,644	82,511	85,536	99,335	111,152	124,710
Narrow money (M1)	28,719	32,620	35,860	41,645	46,599	52,283
Currency outside banks	7,634	8,464	7,731	8,540	9,213	10,068
Demand deposits	21,086	24,156	28,129	33,104	37,386	42,215
Quasimoney	40,566	46,076	45,505	52,846	59,132	66,345
Time deposits	38,390	43,605	43,334	50,326	56,312	63,181
Other quasimonetary deposits	2,176	2,471	2,170	2,520	2,820	3,164
Foreign currency deposits	3,359	3,815	4,172	4,844	5,421	6,082
	(Change in percent of broad money 12 months earlier)					
Net foreign assets	12.9	5.7	4.5	9.9	5.2	5.1
Net domestic assets	2.7	7.8	13.3	6.3	6.7	7.1
Net domestic credit	4.6	7.9	14.2	6.3	6.8	7.1
Net claims on the central government	0.2	1.4	0.3	-1.7	-0.4	0.2
Credit to the economy	4.6	6.5	14.3	8.0	7.2	7.0
Credit to public enterprises	0.4	0.0	0.3	0.1	0.0	0.0
Credit to private sector	4.2	6.5	14.0	8.0	7.2	6.9
Other items (net)	-1.9	0.0	-0.9	-0.1	0.0	0.0
<i>Selected monetary indicators:</i>						
Income velocity of money	1.31	1.27	1.28	1.25	1.22	1.21
Emigrant deposits	28,318	31,339	31,293	36,342	40,665	45,625
Excess reserves /total deposits (percent)	2.1	0.8	1.3	1.0	0.9	0.9
Money multiplier (M2/M0)	3.44	3.69	3.92	4.25	4.29	4.32
Credit to the economy (percentage change)	9.0	13.8	30.0	15.3	13.8	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	Actual		Projections	
(Millions of Cape Verde escudos, unless otherwise specified)						
Bank of Cape Verde						
Net foreign assets	15,308	17,403	20,390	24,931	29,510	35,184
<i>Of which: net international reserves</i>	15,109	17,204	20,216	24,757	29,335	35,009
Foreign assets	16,523	18,618	21,536	26,062	30,577	36,125
Foreign liabilities	-1,215	-1,215	-1,146	-1,131	-1,067	-942
Net domestic assets	5,828	4,965	1,455	-1,538	-3,607	-6,339
Net domestic credit	7,678	6,047	3,518	566	-1,460	-4,150
Trust Fund claims	4,605	4,605	4,605	4,605	4,605	4,605
Net claims on central government	1,882	1,093	1,748	1,748	1,748	1,748
Credit to central government	4,779	4,779	3,739	3,739	3,739	3,739
Deposits of central government	-2,896	-3,685	-1,990	-1,990	-1,990	-1,990
<i>Of which: project accounts</i>	-351	-277	-716	-277	-277	-277
<i>Of which: foreign currency deposits</i>	-1,347	-1,347	-682	-682	-682	-682
Claims on local government	0	0	0	0	0	0
Credit to the economy	1,163	1,163	1,147	1,301	1,437	1,592
Credit to public enterprises	54	54	47	47	47	47
Credit to private sector	1,094	1,094	1,091	1,245	1,381	1,535
Claims on nonbank financial institutions	15	15	9	9	9	9
Credit to commercial banks	27	-815	-3,983	-7,088	-9,250	-12,095
Other items (net)	-1,850	-1,082	-2,063	-2,104	-2,146	-2,189
Assets	2,482	1,442	2,791	2,847	2,904	2,962
Liabilities	4,332	2,525	4,854	4,951	5,050	5,151
Reserve money (M0)	21,136	22,368	21,845	23,393	25,903	28,844
Currency outside banks	7,634	8,464	7,731	8,540	9,213	10,068
Cash in vaults	1,058	1,205	1,457	1,701	1,910	2,148
Deposits of commercial banks	12,443	12,697	12,654	13,149	14,778	16,626
Deposits of private sector	0	0	0	0	0	0
Deposits of other financial institutions	2	2	3	3	3	3
Gross international reserves (millions of euros)	147.4	166.4	193.1	234.2	275.1	325.4
Net international reserves (millions of euros)	137.0	156.0	183.3	224.4	266.0	317.4
Reserve money (12-month change in percent)	14.3	5.8	3.4	7.1	10.7	11.4

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.	Dec.	Dec.
		Program	Actual		Projections	
(Millions of Cape Verde escudos, unless otherwise specified)						
Commercial banks						
Net foreign assets	6,581	8,652	4,747	8,642	9,202	9,185
<i>Of which:</i> excluding the effect of a purchase of a Portuguese credit to Electra	6,581	8,652	8,315	...	...	...
Foreign assets	11,026	13,098	9,749	13,794	14,457	14,545
Foreign liabilities	-4,445	-4,445	-5,002	-5,152	-5,255	-5,360
<i>Of which:</i> nonresident deposits	-3,520	-3,766	-4,214	-4,340	-4,427	-4,516
Net domestic assets	58,428	65,395	73,055	82,153	92,737	105,457
Net domestic credit	66,016	72,982	81,080	90,179	100,762	113,483
Net claims on general government	19,209	20,156	19,279	17,806	17,393	17,599
Trust Fund claims	6,433	6,433	6,433	6,433	6,433	6,433
Other government deposits (INPS)	-569	-569	-488	-488	-488	-488
Net claims on central government	13,324	14,313	13,644	12,172	11,759	11,966
Treasury bonds	9,173	9,847	10,030	8,198	7,367	7,054
Treasury bills	5,609	5,889	5,086	5,340	5,661	6,085
Other credits	484	518	616	616	616	616
Deposits of central government	-1,941	-1,941	-2,088	-1,983	-1,884	-1,790
Net claims on local government	21	-22	-311	-311	-312	-312
Claims on local government	276	236	271	277	282	288
Deposits of local government	-256	-258	-582	-588	-594	-600
Credit to the economy	33,333	38,110	43,708	50,435	57,432	65,015
<i>Of which:</i> excluding purchase of a Portuguese credit to Electra	33,333	38,110	39,314	...	...	...
Credit to public enterprises	377	443	587	631	656	689
Credit to private sector	32,945	37,656	43,114	49,797	56,769	64,319
Claims on nonbank financial institutions	11	11	6	6	6	6
Net claims on the Bank of Cape Verde	13,473	14,717	18,094	21,938	25,938	30,869
Total reserves	13,500	13,902	14,111	14,850	16,687	18,774
Vault cash	1,058	1,205	1,457	1,701	1,910	2,148
Deposits with central bank	12,443	12,697	12,654	13,149	14,778	16,626
Required reserves	11,052	12,117	11,670	12,283	13,856	15,647
Excess reserves	1,391	579	984	866	921	979
Credit to the Bank of Cape Verde	-27	815	3,983	7,088	9,250	12,095
Other items (net)	-7,587	-7,587	-8,026	-8,026	-8,026	-8,026
Deposit liabilities to nonbank residents	65,009	74,047	77,802	90,795	101,939	114,643
Local currency deposits	61,650	70,232	73,631	85,950	96,518	108,561
Demand deposits	21,084	24,156	28,126	33,104	37,386	42,215
<i>Of which:</i> emigrant deposits	3,394	3,756	4,043	4,695	5,254	5,895
Quasimoney	40,566	46,076	45,505	52,846	59,132	66,345
Time deposits	38,390	43,605	43,334	50,326	56,312	63,181
<i>Of which:</i> emigrant deposits	23,825	26,367	26,148	30,367	33,979	38,124
Other quasimonetary deposits	2,176	2,471	2,170	2,520	2,820	3,164
Foreign currency deposits	3,359	3,815	4,172	4,844	5,421	6,082
<i>Of which:</i> emigrant deposits	1,100	1,217	1,102	1,280	1,432	1,607
Memorandum items:						
Emigrant deposits (as ratio to total deposits)	0.44	0.38	0.40	0.40	0.40	0.40
Other deposits (as ratio to total deposits)	0.61	0.62	0.63	0.63	0.63	0.63
Composition of emigrant deposits	1.00	1.00	1.00	1.00	1.00	1.00
Local currency	0.96	0.96	0.96	0.96	0.96	0.96
Demand	0.12	0.12	0.13	0.13	0.13	0.13
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
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**GOVERNMENT OF CAPE VERDE
LETTER OF INTENT**

April 17, 2007

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

Dear Mr. de Rato:

1. Cape Verde's three-year Policy Support Instrument (PSI), approved by the IMF Executive Board in July 2006, is designed to support the government's economic objectives and policy framework for 2006-09. The PSI program focuses on measures to:
 - Consolidate macroeconomic stability, notably by reducing public debt and increasing official foreign exchange reserves;
 - Improve public sector financial management, including by strengthening macroeconomic coordination and planning, stopping arrears, broadening the tax base, and improving internal and external audit processes;
 - Reduce fiscal risks, including those that could arise from operations of state-owned enterprises; and
 - Strengthen regulation and supervision of the financial sector, particularly in the growing offshore financial center.
2. Details of this program are set out in the initial Memorandum of Economic and Financial Policies (MEFP) of July 2006, which was updated in December 2006 in conjunction with the first review of the program.
3. This Letter of Intent reflects understandings reached *ad referendum* with an IMF staff team during discussions on the second review of the PSI in March 2007. In this letter, the government affirms its ongoing commitment to the macroeconomic and structural objectives of the PSI program. It believes this program will provide firm support for sustained growth, development, and poverty reduction in Cape Verde.
4. In the government's view, Cape Verde's economic and policy performance remains strong and in full accord with the PSI. As discussed below, the outlook for growth and

inflation is favorable; fiscal and monetary policies are consistent with program goals; and important progress is being made toward the structural objectives of the program.

Growth and inflation

5. Recent indicators—including strong consumption and investment demand, high business confidence, and a significant pickup in tourism arrivals—suggest that GDP growth in 2006 may have been higher than expected. Hence, the growth estimate for 2006 has been revised up to 6.5 percent. For 2007, growth is projected to be even stronger at around 6.9 percent, reflecting in part the further increase expected in foreign direct investment inflows. “Headline” inflation rose in late-2006 following a court ruling that required a change in the way value-added taxes were applied to certain products. However, the pre-existing price structure was largely restored in the 2007 Budget Law and this, together with the expected continuation of trend declines in fresh food items, should see twelve-month inflation return to low single-digit rates during 2007.

Macroeconomic policies.

6. The budget outturn in 2006 was marked by higher-than-projected tax revenues, firm restraint on recurrent public spending, and a record-high execution rate of the public investment program, reaching over 80 percent. Domestic borrowing increased unexpectedly near the end of the year, however, mainly because of delayed proceeds from land sales and privatization together with profit transfers from public enterprises that were lower than anticipated. As a result, the program ceiling on net domestic borrowing was exceeded. The government requests a waiver for missing this assessment criterion, on the basis of correction actions that will be taken in 2007. In particular, as the delayed proceeds arrive in 2007, the government intends to use these to unwind the higher-than-expected borrowing that arose in 2006. If necessary, the government will propose changes in the 2007 budget to the National Assembly that would put into effect its policy intentions. In addition, the government will strengthen its ability to monitor and forecast revenues and financing flows. In other respects, this year’s fiscal program continues to reflect the 2007 budget. Specific program objectives for 2007 are set out in Table A1 (attached).

7. Monetary policy remains fully consistent with the program goal of building up foreign exchange reserves and hence supporting the exchange rate peg. Reserves reached 3.0 months of prospective imports at the end of 2006 and, in 2007, the Bank of Cape Verde (BCV) aims to increase reserves by at least a further 0.1 months of imports. The BCV considers that the amount of excess liquidity in the banking system may have eased over recent months, mainly as a result of rapid growth in private sector credit and the Bank’s sterilization of foreign exchange inflows. The BCV will, however, continue to monitor the liquidity situation closely and its implications for domestic interest rates and credit growth, and adjust policy operations as appropriate. The BCV will also continue to explore options for improving its operating framework for monetary policy and liquidity management,

including the role that closer monitoring of external interest differentials could play in this regard.

Structural Reforms

8. The government remains committed to moving ahead with reforms to improve public sector financial management. Key steps in the period ahead include:

- Finalizing draft legislation to support the streamlining of tax incentives and exemptions. By end-December 2007, the government intends to submit to the National Assembly legislation that would establish the overall framework for formulating specific policy actions in this area. While this timing represents a slight delay from that originally envisaged, the government is determined to push forward with its plans to rationalize tax exemptions, in coordination with other tax reform initiatives. In particular, during the second half of the year the government will also submit the revised General Tax Code (CGT) to the National Assembly, together with the new Code on Judicial Processes (CPJ) and draft bills covering individual and corporate income taxes (IRC and IRS). These goals are reflected in the attached table of structural benchmarks.
- Strengthening the structure, functioning, and management of the DGCI, drawing on the recommendations of recent technical assistance from the IMF. A strategy for reform will be finalized by December 2007, including reform priorities, an implementation schedule, and budgetary requirements. The government aims to complete these reform by the end of 2008. As part of this effort, a Large Tax Payers Unit has been established and will be fully operational by end-June 2007.
- Strengthening external and internal audit processes. In particular, a new law concerning the Court of Auditors (TdC) has been approved by the Council of Ministers and submitted to the National Assembly. An additional judge has already been appointed for this Court. In addition, a new customs audit court is to be set up and the Tax Inspectorate will be strengthened and modernized. As for internal audit, the Inspectorate General of Finance has been reinforced with additional staff and brought within a new organic law, and quarterly accounts now produced through the SIGOF system will allow for closer monitoring and control of budget execution.
- Fully implementing measures to prevent the accumulation of public sector payment arrears, including among semi-autonomous agencies and municipalities. As discussed in the MEFP for the first review, the Ministry of Finance is implementing a procedure whereby, if semi-autonomous agencies continue to incur arrears to Electra, the Treasury will make these payments directly to Electra and deduct the corresponding amounts from transfers to the agencies concerned. The same approach will be used if the semi-autonomous agencies incur arrears to other entities. Further arrears were accumulated in the final months of 2006, however, while these new procedures were

being put in place. The government requests a waiver for not meeting the assessment criterion on non-accumulation of arrears, on the basis of the corrective measures now being implemented. Following a high-level meeting with municipalities to address their obligations to Electra, municipalities have signed a memorandum of understanding accepting their responsibilities in this regard. The government aims to ensure full compliance of municipalities with this agreement. The government will also introduce a tax on consumer electricity bills to meet the costs of public lighting, including a margin for clearing accumulated payment arrears that have arisen in this area.

- Improving the processes of budget formulation, execution, and monitoring. The sectoral coverage of the medium-term expenditure framework (MTEF) is steadily being expanded and this, together with the MTEF's global framework for revenue and spending, will support the preparation of the state budget for 2008 and future years. Implementation of the SIGOF system, whose coverage is also increasing, is providing a valuable tool for controlling budget execution and for monitoring outturns.

9. The government is also preparing to implement a number of civil service reforms. A draft Civil Service Framework Law will be sent to the National Assembly by mid-year and is expected to come into force in 2008. Key objectives of this law include (a) introducing greater mobility between public and private sectors to facilitate more efficient and flexible human resource management and improve management of supernumerary staff; (b) lowering the costs of retirement to the government, including by increasing the retirement age, length of service, and single social tax, and also introducing provisions for early retirement; (c) introducing a system of paid internships for young graduates to allow new job seekers the chance to gain public sector experience; (d) introducing provisions for unlimited leaves of absence. Associated with these reforms, the government also plans to approve a number of new decrees concerning public sector employment, also to be implemented in 2008. These include a revision of the system of Posts, Career Paths and Salary Scale, with the purpose of restructuring the technical career streams and other senior management and regular staff categories of the Civil Service, devising a new professional development tool, and introducing a new salary scale and a new performance assessment system.

10. The government remains committed to improving the regulatory frameworks for the energy sector. The automatic adjustment mechanism for electricity and water tariffs was approved and published in January 2007 and, by May 2007, the Economic Regulatory Agency (ARE) expects to finalize and publish the mechanism for establishing base tariffs. This goal will be included as a mid-2007 assessment criterion in the program. Furthermore, ARE intends to apply the adjustment mechanism for retail fuel prices with minimal delay: after the oil companies submit the relevant data on the costs of each shipment of oil imports, ARE will fully and rapidly reflect these data in the adjustment mechanism. From mid-2007 on, the program will include continuous assessment criteria to support full and systematic implementation of these electricity, water, and fuel tariff mechanisms.

11. To support the prioritization of public investment spending and management of debt and contingent liabilities, the government intends to adopt a medium-term approach toward identifying investment needs and availability of financial resources. In particular, this strategy will include the investment priorities of the government and of state-owned enterprises, the potential sources of concessional external financing and domestic financing, and the possible needs for less-concessional government and government-guaranteed external borrowing. In addition, the government will continue to explore ways in which it might guarantee some but not all of the risks associated with borrowing by state-owned enterprises—covering, for example, risks arising from government policy decisions but not the full range of operational risks.

12. The BCV is moving ahead with its action plan for strengthening the regulatory environment for the financial sector. Particular attention is being given to the offshore banking center in view of the reputational risks that could arise if this area is not adequately regulated. A consultant's report assessing the legal and institutional framework has been completed and, following discussions with key stakeholders, specific legislative proposals will be prepared. The BCV expects to complete these steps by December 2007. An AML/CFT assessment mission from the IMF is planned for the second quarter of 2007. In addition, the BCV is pursuing a range of training, familiarization, and other capacity building exercises.

13. 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-yearly 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.

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

Sincerely yours

/s/

Cristina Duarte
Minister of Finance and Public Administration.

Attachments:

Table A1: Quantitative Assessment Criteria and Benchmarks

Table A2: Structural Assessment Criteria and Benchmarks

Technical Memorandum of Understanding

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

Objectives	Conditionality	Timing	Status
Structural Assessment Criteria			
Reduce fiscal risks.	Fully implement the automatic utility tariff adjustment mechanism.	End-March 2007	Met
Structural Benchmarks			
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 operating in Cape Verde.	End-December 2006	In preparation
Improve budget prioritization	Implement the MTEF.	End-June 2007	In preparation
Strengthen financial regulation.	Implement recommendations of the task force on financial sector reform.	End-June 2007	In preparation
Streamline tax incentives.	Submit draft legislation to the National Assembly on streamlining tax incentives and exemptions.	End-December 2007	Previously end-June 2007; reforms in preparation
Strengthen the tax base.	Submit the revised income tax code to the National Assembly.	End-December 2007	Previously end-June 2007; reforms in preparation
Strengthen fiscal control.	Implement laws to strengthen the Court of Auditors (TdC) and the National Chart of Public Accounts.	End-June 2007	In preparation
Supplementary Measures⁷			
Structural Assessment Criteria			
Reduce fiscal risks.	Finalize and publish the mechanism for setting base utility tariffs	End-June 2007	
Reduce fiscal risks.	Fully apply mechanisms for setting and adjusting electricity, water, and fuel prices	Continuous as of July 1, 2007	
Structural Benchmarks			
Strengthen the tax base.	Large taxpayers unit to be fully operational	End-June 2007	
Strengthen tax administration.	Finalize reform strategy for DGCI	End-December 2007	
Strengthen the tax base.	Submit the new General Tax Code to the National Assembly.	End-December 2007	
Strengthen the tax base.	Submit the new Code on Judicial Processes to the National Assembly.	End-December 2007	
Strengthen the tax base.	Submit the draft individual and corporate income taxes bills to the National Assembly.	End-December 2007	

⁷ Measures added in second program review.

APPENDIX I, ATTACHMENT I

CAPE VERDE: TECHNICAL MEMORANDUM OF UNDERSTANDING⁸

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 the end of the previous year 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

⁸ Unchanged from CR/07/44, except for Section II that has been replaced.

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 Table A1 of the Letter of Intent. 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 CRITERIA⁹

A. Finalize and publish the mechanism for setting base utility tariffs

17. The condition for finalizing and publishing the mechanism for setting base electricity and water tariffs will be deemed complete when (i) the technical specifications have been agreed upon between Electra and the autonomous Economic Regulatory Authority (ARE); (ii) the details of the base tariff setting mechanism have been published; and (iii) base tariff levels are brought in line with the agreed mechanism.

B. Continuous application of the mechanisms for setting and adjusting electricity, water, and fuel prices

18. The condition will be deemed met when (i) base utility tariffs are set, and reset with the periodicity, as specified in the agreed base tariff setting mechanism; (ii) between resetting of base tariffs, utility tariffs are adjusted whenever input costs since the last adjustment have

⁹ See Table A2 of the Letter of Intent of April 17, 2007.

changed cumulatively by more than three percent as specified in the published utility tariff adjustment mechanism; and (iii) within one month of each import shipment of petroleum products, retail petroleum product prices are adjusted and brought in line with the specifications in the retail petroleum price adjustment mechanism.

III. OTHER DATA REQUIREMENTS FOR PROGRAM-MONITORING PURPOSES

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



Press Release No. 07/89
FOR IMMEDIATE RELEASE
May 8, 2007

International Monetary Fund
Washington, D.C. 20431 USA

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

The Executive Board of the International Monetary Fund (IMF) has completed the second 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 intended to help the country reduce macroeconomic risks, provide a margin for safety against shocks, and prepare for a possible longer-term decline in access to concessional external financing. Key measures are directed to reducing public debt, building up international reserves, improving public financial management, and strengthening financial sector and energy sector regulation.

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 semiannually, irrespective of the status of the program (see [Public Information Notice No. 05/145](#)).

Following the Executive Board's discussion of Cape Verde, Mr. Murilo Portugal, Deputy Managing Director and acting Chair, said:

“Cape Verde continues to demonstrate strong economic performance, supported by the authorities’ commitment to maintain sound macroeconomic policies and to push ahead with a wide range of structural reforms. Growth is being reinforced by significant increases in foreign direct investment, especially in the tourism sector. Reflecting this favorable performance, the growth estimates for 2006 and 2007 have been revised up. Inflation is declining and is expected to return to low single-digit levels by the end of this year.

“Fiscal and monetary policies are on track to meet or surpass objectives of the program under the Policy Support Instrument (PSI)—notably, the reduction in domestic debt as a share of GDP and the build-up of official foreign exchange reserves.

“The government is preparing a number of important reforms to improve public sector financial management, including measures to strengthen budget implementation, audit processes, and the tax codes—including a much-needed streamlining of tax exemptions. Also of critical importance is the full implementation of procedures being put in place to end the problem of public sector payment arrears. In addition, the government’s plans to develop a medium-term public investment plan, including for the state-owned enterprises, will help with the prioritization of investment projects and the identification of financing options.

“To safeguard Cape Verde’s good reputation, it is important for the authorities to push ahead with reforms to strengthen financial sector regulation and supervision, including in the offshore sector and with regard to provisions for anti-money laundering and combating the financing of terrorism (AML/CFT). Financial sector development needs to be undertaken prudently and in conformity with international best practice.

“The implementation earlier in 2007 of the automatic adjustment mechanism for utility tariffs is a welcome development, as this will support energy sector growth and reduce fiscal risks. To complement this measure, the mechanism to determine base tariff levels should be applied by mid-2007 as planned, and adjustments in retail fuel prices need to take place automatically and transparently,” Mr. Portugal.

**Statement by Laurean W. Rutayisire, Executive Director for Cape Verde
May 7, 2007**

1. I would like to express my appreciation of the fruitful dialogue that staff has maintained with the Cape Verdean authorities during the recent discussions on the second review under the Policy Support Instrument (PSI). I also appreciate the constant support that Management and the Executive Board have accorded to Cape Verde. Keeping up with their firm attachment to transparency, my authorities have consented to the publication of the letter of intent and the staff report.

2. Through the implementation of the PSI-supported program, the authorities continue to cope well with the challenges facing Cape Verde, notably in the run-up to its imminent graduation from least-developed-country status. In line with program objectives, strong implementation of their ambitious reform program is contributing to increased resilience of the economy to shocks, lower risks to the economic outlook, diminishing liabilities of the public sector, and increasing foreign reserves. Accordingly, actual macroeconomic performance, in a number of fronts, has exceeded targeted performance under the PSI, particularly in terms of growth, reserve accumulation, revenue mobilization, and reduction of domestic debt in percent of GDP.

RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM

3. In 2006, economic developments in Cape Verde were positive. Growth was higher than estimated, reaching about 6.5 percent. The authorities' fiscal discipline and good execution of public investment provided a favorable environment for this strong growth performance. After an upsurge in late-2006 due to a court-ordered change in the application of VAT to a number of products, consumer inflation has since been declining.

4. Fiscal performance was strong in 2006, translating the authorities' strong commitment to the fiscal program. Preliminary estimates show that fiscal deficit was about 3.8 percent well below program target. The authorities' efforts to strengthen tax administration contributed to the mobilization of higher-than-projected tax revenues. In order to bolster this higher revenue mobilization, a large taxpayers unit was recently established at the Ministry of Finance and is expected to be fully operational by mid-2007. On the expenditure side, control is being exercised over recurrent public spending and public investment. The authorities are making progress in clearing domestic arrears. The domestic debt-to-GDP ratio was markedly reduced. Notwithstanding the authorities' strong efforts to move forward with the structural agenda, two quantitative assessment criteria were missed however. The first relates to the accumulation by semi-autonomous government entities of arrears to the electricity company, Electra. In order to avoid the reoccurrence of this problem, the government is determined to make direct payments to Electra, if these entities accumulate new arrears, and subsequently deduct the amount paid from the government transfers that are allocated to them. The authorities have also approved and published recently the automatic adjustment mechanism for electricity and

water tariffs. The second missed assessment criterion concerns domestic borrowing which exceeded program ceiling as a result of delays in the mobilization of proceeds from land sales and privatization and lower-than-anticipated profit transfers from public enterprises. The authorities plan to use the delayed proceeds when these become available to clear the additional domestic debt that has been contracted. It is also the intention of the authorities to improve the monitoring and forecasting of revenues and financing flows and, in this endeavor, they are hopeful that IMF technical assistance will be provided. In light of the remedial measures that have been promptly taken, the authorities request waivers for these two missed assessment criteria.

5. On the monetary front, emphasis has been put by the monetary authorities on increasing foreign reserves in support of the exchange rate peg with the euro. At the same time, the Bank of Cape Verde (BCV) has been actively managing liquidity by issuing its own bills. The BCV is continuing to explore a formal operating framework based on closer monitoring and targeting of interest rate differentials between on-shore and off-shore banks as well as between the euro area. The BCV is seeking continued technical assistance from the Fund in support of the ongoing strengthening of monetary policy operations, particularly in the areas of supervision of financial institutions and liquidity management.

PROGRAM FOR 2007

6. In 2007, growth is projected to be around 6.9 percent, mainly driven by foreign direct investment. With tight control over public spending and ongoing efforts to boost revenues, fiscal deficit is expected to be in the neighborhood of 3 percent. Average consumer inflation is projected to be low in 2007 as fresh food prices continue to trend downward. The authorities are determined to make further progress in reducing domestic debt which, in percent of GDP, is expected to be significantly below its initial target for end-2007.

Fiscal Policy and Reform

7. Going forward the authorities remain committed to fiscal discipline and sound budgetary processes. They intend to continue taking steps for strengthening tax administration and reducing fiscal risks, especially those emanating from the energy sector. As part of their efforts to streamline tax incentives and exemptions, the authorities are preparing a revised General Tax Code and a Code on Judicial Processes, which they intend to submit to the National Assembly during the second half of 2007. In this endeavor, they would also welcome IMF technical assistance, particularly in the process of developing criteria for granting tax exemptions. The authorities will also aim at making progress in improving budget formulation, execution, and monitoring. They are currently expanding the coverage of the medium-term expenditure framework and they are hopeful that this work will be completed by end-June 2007.

8. The authorities see merit in staff's recommendation that a comprehensive medium-term investment plan be developed with a view to supporting prioritization of public investment and management of debt and contingent liabilities. However, my Cape Verdian authorities face capacity limitations that can hinder a successful implementation of this approach, especially in debt management, accounting, and debt sustainability analysis, and they would welcome Fund technical assistance in these areas.

Monetary Policy and Financial Sector Reform

9. The central bank of Cape Verde (BCV) will continue building reserves in line with the monetary program objectives and in support of the country's exchange rate regime. In this regard, it expects the level of reserves at end-2007 to be slightly higher compared with that of end-2006 which covered three months of prospective imports. The BCV will also aim to sterilize liquidity by issuing its own bills, which, combined with the significant growth in private sector credit, should keep easing excess liquidity in the banking system.

10. The BCV will continue to take steps for devising an action plan for improving the financial sector's regulatory framework. In particular, this should help address vulnerabilities related to the offshore center. Since the assessment of the legal and institutional framework has been completed and key stakeholders have been consulted, the BCV is hopeful that specific legislative proposals will be finalized by December 2007. The strengthening of this regulatory framework will help ensure that commercial banks continue to receive sustained and large remittance inflows from Cape Verdian emigrants. The authorities are aware of the concerns over the risks of reversal flows of emigrant deposits as the spread between the emigrant deposit rate and the euro area rate narrows. In addition to interest rate differentials, there is a variety of factors that can determine the level of remittances flows to Cape Verde. Further analysis of these factors in a Selected Issues paper can be useful in shedding light on the actual risk of withdrawal of emigrant deposits. In the meantime, the Cape Verdian authorities will continue to closely monitor interest rate differentials and stand ready to take action as appropriate.

11. The AML/CFT assessment mission which is expected to be conducted by the IMF in Cape Verde in the second quarter of 2007 will complement the authorities' efforts to address vulnerabilities in the financial sector.

Other Structural Reforms

12. The authorities aim to make further progress in strengthening external and internal audit process. After its approval by the Council of Ministers, a draft law relating to the Court of Auditors has been submitted to the National Assembly. The authorities have increased the number of judges and staff assigned to this Court and the financial audit department. They intend to take additional steps to strengthen the tax audit department.

13. As noted above, the government has put in place an automatic adjustment mechanism for water and electricity tariffs following its decision in June 2006 to eliminate subsidies to Electra. Going forward, the application of this mechanism will help reduce fiscal risks. The authorities now intend to finalize and publish by end-June 2007 the mechanism for setting base utility tariffs.

14. Finally, the authorities are determined to persevere in their ongoing efforts to undertake key civil service reforms, notably with a view to enhancing mobility between the private and public sectors, reducing retirement costs borne by the government, and increasing employment opportunities for job seekers.

15. In conclusion, I agree with staff that Cape Verde continues to display commendable economic and policy performance. In this light and in view of the corrective actions the authorities have taken, I would appreciate that Directors support their requests for waivers for the two missed assessment criteria on non-accumulation of arrears and domestic borrowing and completion of the second program review.