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October 12, 1984

To: Members of the Executive Board

From: The Secretary

Subject: São Tomé and Principe - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with São Tomé and Principe. A draft decision appears on page 16.

This subject will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. J. Hill (ext. (5)8665) or Mr. Dairi (ext. (5)8670).

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INTERNATIONAL MONETARY FUND

SAO TOME AND PRINCIPE

# Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the 1984
Consultation with Sao Tomé and Principe

Approved by J.B. Zulu and S. Kanesa-Thasan

October 11, 1984

## I. Introduction

The 1984 Article IV consultation discussions with Sao Tomé and Principe were held in Sao Tomé during the period June 27-July 11, 1984. The representatives of Sao Tomé and Principe included Mr. Agapito Mendes Dias, Minister of Planning (and Acting Governor of the Central Bank), Mr. Celestino Costa, Minister of Commerce, Mr. Fausto Vera Cruz, Director of the Central Bank, and Mr. Hildeberto Mario Seca, Advisor in the Central Bank. The staff representatives were Mr. J. Hill (head-AFR), Mr. G. Muirragui (BUR), Mr. R. Hicks (EUR), Mr. M. Dairi (AFR), and Ms. M. Sucharov (secretary-AFR). Mr. M. Del Buono (IBRD) also participated in most of the discussions.

The last consultation discussions were held in March/April 1982. Sao Tomé and Principe has not used Fund resources and continues to avail itself of the transitional arrangements of Article XIV. Summaries of relations with the Fund and the World Bank group are provided in Appendix I and basic data are provided in Appendix II.

## II. Background

Sao Tomé and Principe consists largely of two islands (964 square kilometers) located in the Gulf of Guinea with a total population estimated at about 100,000 people. This small tropical island economy is heavily dependent upon a single export crop--cocoa--which accounts for about a third of GDP and 90 percent of export earnings. The production of cocoa, as well as of the secondary export crops of copra, palm kernels, and coffee, has experienced a long-term decline. Cocoa production, for example, which reached a peak of 33,000 tons per year on average during the second decade of this century, averaged 10,000 tons per annum during the 1960s and the early 1970s, but dropped to only 7,400 tons in 1974. Following independence from Portugal in 1975, the Government nationalized the private plantations into 15 public enterprises which are closely controlled by the Government and are expected to provide considerable financial resources to the Treasury. From independence to 1980, cocoa production remained at only a little below the

1974 level, but since 1981 it has declined further to about 4,200 tons per year (Table 1). This dwindling production base, together with other structural problems-for example, high unit costs of production, excessive dependence on imports, geographic isolation, limited administrative capacity--have constrained severely the country's economic growth and development as well as the Government's ability to formulate and implement sound economic and financial policies.

## III. Recent Economic Developments

Recent economic developments in Sao Tomé and Principe are unusually difficult to quantify owing to the paucity of reliable economic and financial data. There are no official national accounts, nor are there any production, trade or price indices. Official presentation of the fiscal, monetary, and external accounts suffers from serious deficiencies, including incomplete coverage, insufficient disaggregation, conceptual inconsistencies, and numerous recording errors. In the fiscal accounts, for instance, and particularly in extrabudgetary operations, inadequate coverage and various changes in recording and classification procedures, complicate the determination of trends, even in such key elements as total government wages, investment, and foreign borrowing. The monetary data do not clearly distinguish between those operations carried out by the National Bank (Banco Nacional de São Tomé e Principe) as the monetary authority and those which it transacts as a deposit money bank. External debt data are not systematically compiled nor are they reported to the World Bank. These deficiencies, which result primarily from a serious shortage of trained personnel, make it difficult to reconcile the official statistics and to present them in a meaningful analytical framework. For this reason, the authorities have not regularly submitted financial data to the Fund and Sao Tomé and Principe does not have a country page in the International Financial Statistics. For the purpose of this consultation report, the staff has made some tentative estimates of production and price developments and has undertaken extensive, though rough and tentative, modifications of the official financial series.

Real economic growth is estimated by the staff to have been substantially negative in recent years as the production and export of cocoa, as well as of other cash crops, declined and remained depressed at historically low levels; the production of domestic food crops also appears to have declined. The disappointing cocoa harvests have been characterized by a continuous fall in yields, due largely to managerial and organizational problems, insufficient applications of fertilizer and pesticides, outmoded equipment and ageing trees, and a reduction in the agricultural labor force. Some of the cultivated areas have been neglected, if not effectively abandoned. The situation was exacerbated, especially at the height of the drought in 1983, by shortages of commercially distributed foodstuffs, which contributed to widespread absenteeism as the workers left the plantations in search of food. The declining cocoa harvests were accompanied by depressed world market prices.

Table 1. Sao Tomé and Principe: Selected Economic and Financial Indicators, 1981-84

| | 1981 | 1982 | 1983 | 1984 Staff Forecast |
|---|---|---|---|---|
| | | (In tons) | | |
| **Production and Income** | | | | |
| Cocoa 1/ | 5,279 | 4,081 | 4,346 | 4,500 |
| | | (Annual percentage change) | | |
| GDP (nominal) | -21.2 | 2.4 | 5.4 | 5.3 |
| GDP (real) | -24.2 | -3.3 | -11.0 | -11.9 |
| GDP deflator | 4.0 | 6.0 | 18.4 | 19.4 |
| **Public finance** | | | | |
| Budget revenue | ... 2/ | -16.6 | -3.6 | 15.8 |
| Expenditure | ... 2/ | 57.5 | -19.2 | 50.3 |
| Of which: investment | (...)2/ | (123.1) | (-57.2) | (143.0) |
| | | (As percent of GDP) | | |
| Budget revenue | 50.1 | 40.7 | 37.4 | 41.1 |
| Expenditure | 66.5 | 102.2 | 78.4 | 112.0 |
| Of which: investment | (26.3) | (57.4) | (23.3) | (53.8) |
| Overall deficit | -20.1 | -55.3 | -57.5 | -78.8 |
| Consolidated operating deficit of state plantations | -15.3 | -7.7 | -12.0 | ... |
| **Monetary aggregates** | | (Annual percentage change) | | |
| Domestic assets | 112.3 | 51.0 | 24.6 | 45.3 |
| Broad money | 5.2 | 13.4 | 32.8 | 30.0 |
| Of which: currency in circulation | (11.7) | (4.6) | (52.9) | (...) |
| **External sector** | | | | |
| Exports, f.o.b. | -53.4 | 31.1 | 1.3 | 71.6 |
| Imports, f.o.b. | -19.7 | 30.5 | -32.4 | 68.5 |
| Current balance (percent of GDP) | -54.1 | -77.7 | -27.0 | -57.0 |
| External debt service (percent of exports of goods and nonfactor services) | 6.3 | 19.5 | 22.6 | 30.2 |
| Gross foreign assets of banking system (months of next year's imports) | 5.8 | 6.7 | 3.0 | -- |
| Nominal effective exchange rate (annual percentage appreciation) | 8.4 | 12.9 | 20.3 | 12.8 3/ |

Source: Data provided by the authorities of Sao Tomé and Principe; and staff estimates.

1/ Cocoa production averaged 6,400 tons per year during the period 1975-80.

2/ Due to changes in budgetary accounting arrangements in 1981, the growth rates for that year cannot be computed.

3/ The average for the first half of 1984 compared with the average of 1983.

As the foreign exchange constraints grew tighter with the drop in cocoa export earnings, the limited availability of imported raw materials and intermediate goods caused value added in manufacturing to decline and that of energy to stagnate.

The poor growth performance of recent years appears to have been accompanied by an increase in the underlying rate of inflation, fueled largely by shortages of consumer goods--including local foodstuffs traded in the uncontrolled markets--and made possible by rapid monetary expansion. As nominal wages in the agricultural sector, which employs about two thirds of total wage earners, have been kept unchanged since 1980, the real wage of the majority of the population has fallen substantially. To some extent, the increase in the cost of living was dampened by emergency food aid and by the Government's policy of subsidizing basic imported foodstuffs and petroleum products.

The financial situation of the public sector weakened considerably with the worsening economic performance. Although the plantations were obligated in principle to transfer to the Treasury 80 percent of their planned profits (in 1984 the rate was raised to 95 percent), their contributions during 1982 and 1983 were in fact negligible and some plantations required additional bank credit and direct transfers from the Treasury to finance their current operations. Consequently, budget revenues, which declined by 17 percent in 1982, fell by another 4 percent in 1983; the fall in the latter year would have been more serious except for a large increase in STABEX grants. The erosion of the revenue base was accompanied by a sharp increase in expenditures, especially investment financed from external sources. In 1982 investment more than doubled and was allocated essentially to the construction of a ceramics factory, an extension to the airport, a central mechanical repair shop, and the acquisition of a commercial fishing vessel. In 1983, reflecting the lumpiness of project expenditure in a small economy, investment fell sharply to the level of 1981, but an increase in current expenditures, partly for social services and subsidies to ailing cocoa plantations, offset some of this decline. These developments, together with a deterioration in the balance on extrabudgetary accounts, caused the overall Treasury deficit, which nearly tripled to Db 728 million (55 percent of GDP) in 1982, to widen further to almost Db 800 million (58 percent of GDP) in 1983. During the period 1981-83, about one third of the overall cumulative deficit was financed from external sources. The Government also found it necessary to increase sharply its net recourse to central bank credit thereby contributing to a marked acceleration in the growth of broad money, rising from 5 percent in 1981, to 13 percent in 1982, and to 33 percent in 1983. During the first quarter of 1984 monetary expansion continued at an annual rate of 28 percent, a rate well in excess of the projected growth of nominal GDP.

For 1984 the Government adopted a budget which envisaged an increase in revenue of more than 50 percent. A large part of the increase was to come from higher tax collections on foreign trade and domestic transactions, as well as a resumption in contributions from the cocoa plantations. Current expenditures were budgeted to rise by only 4 percent; a capital spending target was not included in the budget, largely because external sources of financing were not fully known when the budget was formally adopted. Taking into account the budgetary outcome during the first five months of 1984, it is clear that revenues are falling short of those budgeted, partly because contributions from the enterprises remain minimal. Reflecting the pace of implementation of major projects, investment is expected to reach a record level of almost Db 800 million (Appendix II); these outlays are directed mainly towards the construction of additions to the brewery and airport, of a hotel, and of a hydroelectric power plant; and the acquisition of an ocean-going ferry boat. The staff projects that the overall fiscal deficit will widen considerably to about Db 1,150 million (79 percent of GDP) in 1984. Although about one half of the deficit will be financed by foreign borrowing, recourse to central bank credit is likely to reach at least the magnitude of 1983.

Recent balance of payments developments closely reflect the generally weak export performance and the large fluctuations in imports of investment goods. Export earnings, after falling by half in 1981, and partially recovering in 1982, stagnated in 1983 as the volume of cocoa exports fell sharply. This volume reduction occurred because of infrequent arrival of ships; some 1,000 tons of cocoa available for export in late 1983 were not shipped until 1984. Cocoa export unit values, which in 1982 remained 40 percent below the average of the period 1977-79, showed a modest recovery in the second half of 1983. With a large increase in imports of investment goods, the current account deficit rose by almost half to SDR 22.6 million in 1982 (78 percent of GDP). For 1983 the deficit plummeted sharply to SDR 8.3 million (27 percent of GDP), as a result of a decline in investment imports and a marked increase in emergency food aid and STABEX grants; the reduction also resulted from the tightening of controls over imports of raw materials and intermediate goods.

In contrast to 1981, when the overall deficit amounted to SDR 12 million and was largely financed by an accumulation of payments arrears to Portugal for imports of consumer goods, the overall deficit in 1982 declined to only SDR 3.3 million because of a large net inflow of capital, mainly in the form of project financing; there was also some balance of payments support from OPEC and other sources. The overall deficit in 1982 was more than financed by drawing down reserves; outstanding arrears declined slightly as a further accumulation of arrears to Angola (not a member of the Fund), in respect of imports of petroleum products and sales of airline tickets, was more than compensated by settlements to Portugal. In 1983, the overall deficit was limited to SDR 4.1 million and was financed from reserves and a further accumulation of arrears to Angola. The staff estimates that, at the end of 1983, the level of outstanding arrears amounted to about SDR 10 million. Gross reserves, which were equivalent to 6.7 months of imports at the end of 1982, declined to a level equivalent to 3 months at the end of 1983.

The outstanding disbursed external debt is estimated by the staff to have risen from SDR 0.8 million at the end of 1975, to SDR 17.5 million by the end of 1981, and to SDR 54.6 million (170 percent of GDP) by the end of 1984. The rapid growth of the debt has also been accompanied, particularly in recent years, by a weakening of the debt profile. Borrowings in earlier periods--largely from the Soviet Union, the People's Republic of China, Portugal and various international organizations--were highly concessional with relatively long grace periods. More recent loans have carried less concessional terms and some (such as the credit to finance the purchase of the fishing boat and to extend the airport) have been on commercial terms. Consequently, until 1980, nominal debt service payments were insignificant, but they were estimated at SDR 2.3 million in 1983. The ratio of debt service payments to exports of goods and nonfactor services rose from 6 percent in 1981 to an estimated 30 percent in 1984.

Sao Tomé and Principe's currency, the dobra, has been pegged to the SDR at a constant rate of Db 45.25 = SDR 1 since 1977. As a result of this unchanged peg to the SDR, there has been a substantial movement in bilateral exchange rates against currencies of Sao Tomé and Principe's main trading partners in recent years. From the end of 1978 to the end of the second quarter of 1984, the dobra appreciated against the Portuguese escudo by 141 percent, the Dutch guilder by 21 percent, and the pound sterling by 14 percent; by contrast, the dobra depreciated by 20 percent against the U.S. dollar (Chart I). The import-weighted nominal effective exchange rate of the dobra appreciated by 74 percent over the same period. The absence of reliable indices of cost and price developments in São Tomé and Principe precludes a calculation of trends in the real effective exchange rate.

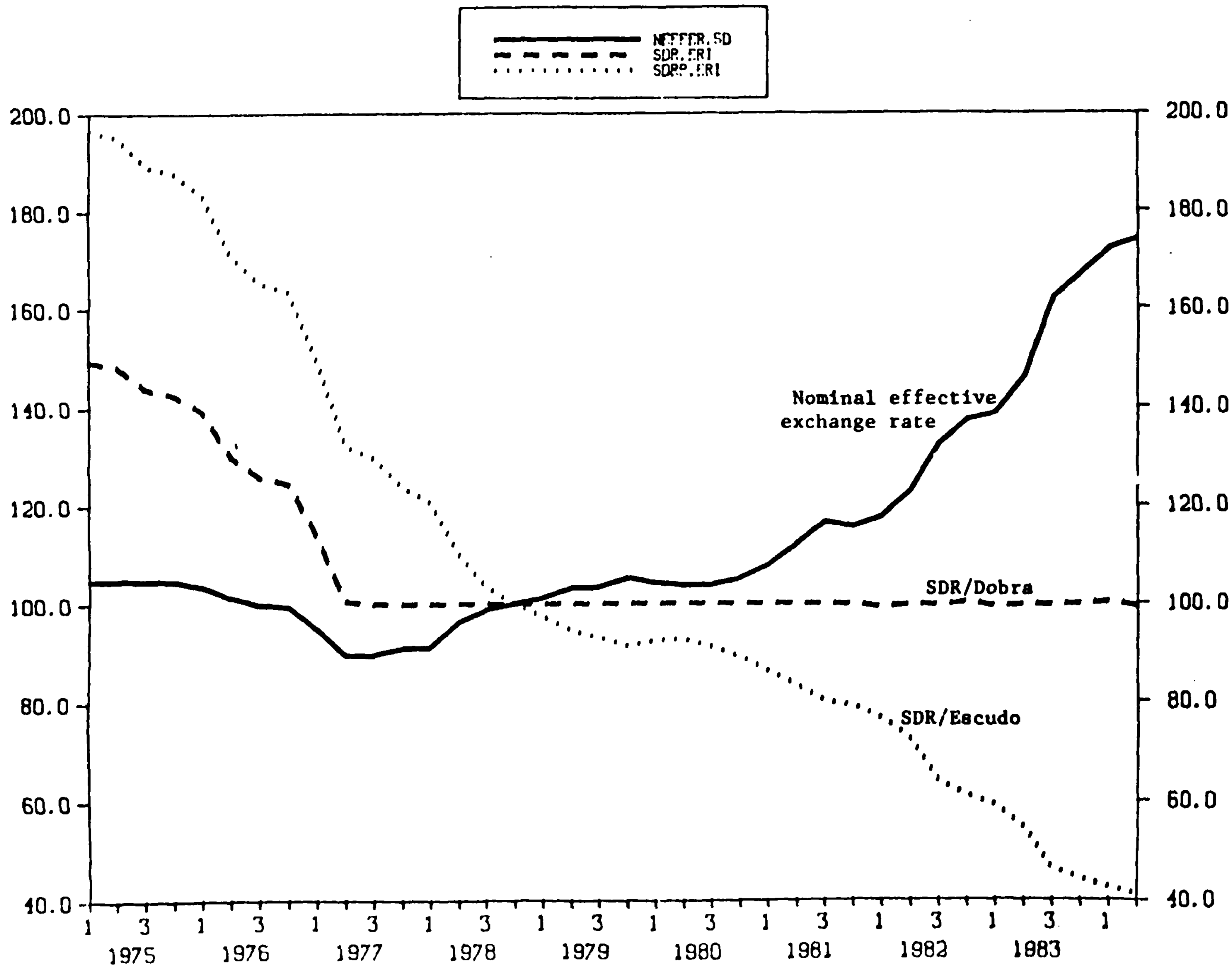
Sao Tomé and Principe maintains a tightly controlled trade and payments system. In January 1984, two adjustments were made to the system as a result of the worsening external position; (i) the limits on foreign exchange purchases for medical expenses abroad were reduced, and (ii) arrangements for the purchase of airline tickets by private citizens for travel abroad were tightened. In 1982 a bilateral payments arrangement with the German Democractic Republic (a nonmember country) became operational; a similar arrangement with Cape Verde has been in effect since 1978.

## IV. Report on the Discussions

Against the background of a worsening economic and financial situation characterized by negative real growth, accelerating domestic inflation, declining reserves, and a rapidly rising external debt service burden, the consultation discussions focused on the policies which the authorities intended to pursue during the rest of 1984 and in the medium term. On the assumption that policies would remain essentially unchanged, the staff projected a balance of payments scenario through 1987 (Table 2), which envisaged a continued stagnation in cocoa production and exports, the maintenance of capital goods imports at the average

**Chart 1**

SAO TOME AND PRINCIPE
EFFECTIVE EXCHANGE RATES
Q4 1978=100



level for the period 1982-84, and continued foreign borrowing on the same average terms as in the recent past. This scenario indicated that there would be significantly higher external current account deficits and that the debt service burden would rise sharply to about 120 percent by 1987. The debt service burden would still rise, on the basis of existing commitments, to about 70 percent by 1987, even if there were no additional loans contracted after mid-1984. The representatives of Sao Tomé and Principe acknowledged their concern about the unfavorable medium-term prospects and stated that the Government was in the midst of a thorough review of its economic and financial policies. In the discussions, the staff representatives took the position that, to meet the critical payments gap emerging in 1984 and to restore viability to the balance of payments over the medium term, the authorities should undertake as soon as possible structural adjustment policies aimed at reactivating production and exports, while reducing the country's excessive dependence on imports.

Table 2. Sao Tomé and Principe: Medium-term Balance of Payments Scenario, 1985-87

(In millions of SDRs)

| | 1985 | 1986 | 1987 |
|---|---|---|---|
| Exports, f.o.b. | 11.3 | 11.3 | 11.3 |
| Imports, f.o.b. | 24.6 | 24.9 | 25.3 |
| Current account deficit | -18.0 | -19.1 | -20.7 |
| Capital account (net) | 18.0 | 19.1 | 20.7 |
| Debt service payments | 7.9 | 12.2 | 15.4 |
| (As percent of exports of goods and non-factor services) | (61) | (94) | (118) |

## 1. Production policies

The representatives of Sao Tomé and Principe indicated that they had been adhering to their official development guidelines, previously established for the period 1982-85, which called for an increase in, and diversification of, agricultural production. This had involved giving emphasis to rehabilitating the cocoa and coffee sectors, expanding production of other export crops (copra and palm kernels), and increasing domestic food supplies (fruits, vegetables, tubers, and pulses). The guidelines also emphasized the development of livestock, fishing, and forestry resources, and envisaged an expansion in energy, communications, and transport infrastructure. These investments were to be supported by increased expenditure on health and education with a view to reducing illiteracy and increasing the supply of trained technicians. Considerable investment had been undertaken in recent years, but the representatives of Sao Tomé and Principe acknowledged that most of the newly completed projects were operating well below capacity and had not contributed significantly to national production, nor were they likely to in the near future. Notable examples included the recently completed ceramics factory and the large central repair shop, both of which were oversized and remain largely idle. Similarly, the considerable resources allocated to the extension of the airport facilities were not considered likely to generate substantial returns in view of the limited demand for international air travel. The fishing boat purchased on commercial terms had indeed boosted fish production, but recently it had been out of commission periodically for need of extensive repairs. Limited success had been achieved in food production projects and greater hope had been placed in a project to increase copra and oil palm production.

The representatives of Sao Tomé and Principe stated that the Government remained committed to economic planning and intended to maintain the general orientation of its development strategy. Without interrupting projects in the energy, transportation and communications fields, they agreed with the staff that a resumption of economic growth crucially depended on the revitalization of agriculture, particularly the rehabilitation of the dominant, but long neglected, cocoa sector. They considered that, in view of the substantial investment already undertaken in this sector, concerted efforts for its revival could be more profitable than the promotion of a new major export crop. Currently they are discussing with the World Bank a loan to finance a rehabilitation project which would entail managerial reforms and technical assistance as well as increased applications of fertilizers and selective replanting of some of the cocoa trees. They also noted that private foreign technical assistance was being sought to accelerate the rehabilitation effort; in this regard, discussions with Portuguese firms were continuing regarding the possibility of their participation in the equity capital of some plantations and, possibly, their management.

The staff representatives welcomed the authorities' intention to focus more of the investment program on agriculture, in general, and on cocoa rehabilitation, in particular, but expressed concern that these projects would not have their potential impact on economic recovery unless they were accompanied by sufficient allocations of foreign exchange to finance agricultural inputs, a substantial improvement in production incentives, and reforms to raise the operating efficiency of the plantaations. The staff noted that, in view of the substantial levels of external food grants committed over the next four years, it should be possible to allocate more foreign exchange to the importation of badly needed fertilizers and pesticides. The staff representatives were also of the view that incentives to the plantation workers should be increased, and that the growing disparity between nominal agricultural wages and those of the public administration should be reduced. A substantial exchange rate adjustment (as discussed in Section IV-3) would provide the enterprises with the financial resources to increase incentives. Corrections to the level and structure of wages should be linked to increases in productivity; in this regard some of the food aid over the next four years could be distributed in the form of productivity awards. Regarding the operating efficiency of the plantations, the staff supported the views of the World Bank, which emphasized the need for managers to be properly trained and remunerated, as well as the need to grant them greater autonomy over operating procedures, employment policy, and investment decisions. The representatives of Sao Tomé and Principe were in broad agreement with the staff on these issues, but noted the obstacles in raising worker productivity resulting from the absence of an indigenous peasant class with an affinity for agricultural activity. The Government had experimented recently with a scheme to pay workers for completed tasks, rather than on a monthly basis, but it was still too early to evaluate fully the results of the experiment.

## 2. Fiscal and monetary policies

The growing fiscal imbalance as well as the monetary expansion of recent years largely reflect the decline of the cocoa sector and the high degree of--what has so far proven to be--generally unproductive investment. Since trends in government revenues are ultimately related to developments in the cocoa sector, a sustained improvement in revenue performance would necessarily depend on the rehabilitation of this sector. The Government has adopted very few discretionary fiscal measures in recent years and those actually introduced, such as the increase in the property tax in 1983, have had only a minor impact on revenue.

The representatives of Sao Tomé and Principe concurred with the staff that the central problems of expenditure policy are the recent growth in current outlays--especially for administration, national defense, and social services--and the quality and productivity of investment. They maintained that, in light of the serious shortage of trained technicians, as well as the need to improve the quality of life for the workers, these current expenditures were necessary. The staff team took the position that controlling the growth of these expenditures was the only reasonable option in light of the stagnating revenue performance and the difficult balance of payments situation. With respect to capital expenditures, the World Bank staff, while generally endorsing the orientation of the government's development objectives and investment program, has been critical of the choice and design of individual projects and the procedures by which they have been executed and monitored. Many investment decisions appear to have been taken without appropriate studies based on sound economic criteria; studies when carried out, have usually been conducted by the creditors and suppliers of capital goods rather than by independent and objective third parties. These shortcomings have contributed to projects with substantial excess capacity and rapidly rising debt service obligations.

The representatives of Sao Tomé and Principe acknowledged that, apart from the decision to suspend temporarily credit to ailing cocoa plantations in 1983, monetary policy has been passive and has accommodated the growing financing needs of the public sector. The authorities did not see the resulting build-up of liquidity in the economy as representing an immediate threat to the external reserve position, because most of the increased liquidity was in the form of working balances of the public trading monopoly, Empresa de Comércio Externo (ECOMEX), and therefore was under their direct control. Moreover, the restrictive import regime was sufficient to control any increase in the demand for imports which might be generated by the growth in currency in circulation. The staff representives noted that, although the liquidity creation might be prevented from exerting excessive pressure on external reserves, the increased currency in circulation, which individuals appear to have accumulated as a result of the severe supply limitations, was certainly a factor contributing to the acceleration in domestic prices in the uncontrolled markets. The staff suggested therefore that the authorities monitor this situation closely and take measures to absorb this excess liquidity, or to mobilize it for productive uses. Accordingly the authorities should consider the sale of aid-related food supplies rather than its free distribution to workers. Furthermore, they might consider raising interest rates to attract this liquidity into the banking system for subsequent rechanneling towards development of domestic resources. The representatives of Sao Tomé and Principe stated that interest rate policy has never played a significant role in their economy; rates remain very low by international standards and have not been changed for more than a decade. However, they added that the scope for a more active interest rate policy was currently under review.

3. External policies

For 1984, despite a substantial, yet temporary, increase in export earnings, the external current account deficit is projected by the staff to more than double to SDR 18.4 million (57 percent of GDP), following a sharp rise (69 percent) in imports. The improved outlook for exports arises primarily from the tonnage carried over from 1983 and, to a lesser extent, from a higher average world market price. The projected import growth will be mostly on account of capital goods used in the construction of the airport and brewery extension, the hotel, and the hydroelectric power plant; as well as the acquisition of an ocean-going ferry. Although official food grants, which in 1984 will be donated largely by the International Red Cross, are expected to remain at the level of 1983, they will be more than offset by sharply higher freight costs. A major increase in net capital inflows will cover the increase in imported investment goods but the overall deficit is projected to widen to SDR 7.6 million.

The representatives of Sao Tomé and Principe were concerned about the payments gap for 1984 and the continuing deterioration in the structure of the external accounts. In early 1984 they concluded an agreement with Portugal to consolidate, into a medium-term loan, an amount of arrears equivalent to SDR 5.2 million (the total amount owed to that country) and, as mentioned above, intensified some restrictions on payments and transfers for current international transactions. They stated that, if the situation warranted, commercial imports would be compressed further and immediate relief sought from certain debts, particularly the remaining accumulated payments arrears (about SDR 5 million), all of which is owed to Angola (not a member of the Fund). Only as a last resort would they seek short-term balance of payments support which would probably have to be secured on commercial terms.

The staff representatives concurred with the authorities that, in view of the adequate volume of strategic food supplies already secured through aid, reducing other imports and seeking debt relief were appropriate approaches to easing the payments position for 1984. However, the staff cautioned the authorities about the undesirable consequences on the debt service burden from contracting additional short-term balance of payments support. In light of the rapid pace at which the unsatisfactory medium-term balance of payments outlook had emerged, the staff urged the authorities to implement corrective external policies in support of those already mentioned in the production, fiscal and monetary fields. These external policies should, as a minimum, include a debt rescheduling, a more restrictive borrowing policy, and an exchange rate adjustment.

With respect to debt relief, the staff team encouraged the authorities to seek both a consolidation of the outstanding payments arrears and a rescheduling of bilateral credits falling due in the medium term on the most favorable terms, hopefully postponing repayments sufficiently far into the future to provide adequate foreign exchange to rehabilitate the cocoa sector and to undertake other necessary structural reforms. To consolidate the gains which may be achieved through rescheduling and to keep the debt service burden manageable in the future, new borrowing should be channelled to directly productive investments, the profitability of which to be clearly established on the basis of objective economic criteria. The financing of infrastructure would be best sought from grants and highly concessional loans.

Although the policy of pegging the dobra to the SDR has been administratively easy, the appreciation of the dobra has contributed significantly to the deterioration of Sao Tomé and Principe's external competitiveness and has militated strongly against an improvement in the external accounts, as it has tended to reinforce the demand for imported goods and severely affected the profitability of the cocoa sector. It has thus rendered substantially more difficult the process of restructuring the economy by developing industries with export and import-substituting potential. The staff representatives pointed out that recent exchange rate policy has seriously reduced the incentive to move resources into the export sector, both because yields on investment in that sector have been held down while the scope for increasing wages to attract and motivate the labor force has been limited. On the import side, the staff argued that the artificially low domestic prices on goods from abroad have led inevitably to increased dependence on imported supplies which in turn has reduced the incentive to develop domestic substitutes. Furthermore, the overvalued exchange rate has biased investment decisions toward projects relying on imported inputs, raising serious problems for their viability in the medium-term.

The staff representatives recommended that, as a vital supporting measure in an effort to restructure the economy, the authorities should adjust the exchange rate. The magnitude of such an adjustment should be guided by an assessment of trends in the effective exchange rate as well as by the size of the external imbalance and the strength of the other related policies. The most important effect of such an exchange rate adjustment would be an increase in the cost of imports which, if passed through to final users, would encourage the development of local resources and thereby reduce the country's dependence on imports. The adjustment would also provide the increased resources needed in local currency to raise the producer price of cocoa paid to the plantations which, in turn, could provide greater incentives to the workers. The staff representatives also suggested that the management of exchange rate policy would be implemented more effectively if the basket to which the dobra was pegged reflected more closely the trading realities of Sao Tomé and Principe than was the case with the SDR. These adjustments, together with a more active and flexible approach to exchange rate policy in the future, should ensure that the exchange rate remain broadly appropriate and assist in promoting the overall structural adjustment effort.

Sao Tomé and Principe maintains a bilateral payments arrangement with the Democratic Republic of Germany (not a Fund member) which became effective in 1982 and extends through 1985. Under this arrangement, Sao Tomé and Principe imports building materials, equipment, and raw materials for the construction and operation of the brewery and ceramics factory; as well as certain consumer goods, especially meat. In return, Sao Tomé and Principe exports to the German Democratic Republic a quantity of cocoa (of at least 1,500 tons) each year. The staff representatives expressed concern that Sao Tomé and Principe, which was now exporting a third of its cocoa crop to a single country under the arrangement, had reduced its flexibility to import priority goods and equipment at competitive prices and to reap the gains from any recovery in world market prices. The representatives of Sao Tomé and Principe replied that they were broadly satisfied with the arrangement and that, thus far, it had worked in their interest. They had found import prices to be generally competitive and, if imports from the German Democratic Republic were not attractive, they could use the cocoa exports to service the debt incurred with that country in conjunction with investments in the construction of the brewery and ceramics factory. Moreover, since the export price under the arrangement was based on the world market price prevailing in 1980, which was higher than the current world market price, Sao Tomé and Principe had profited. They emphatically stated that this arrangement provided security in marketing part of the cocoa crop and, if in their judgement, the terms turned against Sao Tomé and Principe, they would not renew the arrangement or they would seek a renegotiation of the terms. The payments arrangement with Cape Verde is much less important in terms of the size of transactions covered and appears to have been operated in such a way as to ensure speedy settlement of outstanding balances.

## V. Staff Appraisal

Sao Tomé and Principe's economic and financial problems are underlined principally by the long-term decline in the production and export of cocoa, the major determinant of economic activity, and of other cash crops, due in part to an antiquated agricultural infrastructure and an almost total absence of technical and managerial resources. Although following independence, the Government nationalized the plantations and subjected their operations to centralized planning and administration, it has not allocated sufficient investment to this sector nor provided adequate production incentives. Therefore cocoa production over the medium-term will remain stagnant at best, and may even continue to decline. Public investment in recent years, financed largely by external borrowing (on less than concessional terms), has been concentrated principally on energy and transportation, and on import-intensive manufacturing projects which have contributed little to national output and suffer from substantial excess capacity.

The erosion of the cocoa base, the relatively high level of unproductive investment, expansionary fiscal and monetary policies, and the overvaluation of the national currency--resulting from an unchanged peg to the SDR--have contributed to a deteriorating economic and financial situation. With negative real growth and increasing inflation, real wages and per capita incomes have declined in recent years. Rising public spending, largely investment, has contributed to widening fiscal imbalances, an accelerating monetary expansion, and a rising debt service burden. The deteriorating external position has been reflected in accumulating payments arrears and declining foreign exchange reserves.

The staff attaches utmost importance to a substantial reduction in the fiscal deficit. Owing to the limited scope for discretionary tax changes, this objective has to be sought mostly through expenditure cuts, especially through greater selectivity in investment. The economic and financial problems of Sao Tomé and Principe are largely structural in nature. In view of the need to restore viability to the balance of payments over the medium term, the staff believes that the authorities should also aim at reviving the productive sectors and reducing the country's dependence on imports. Towards these ends, investment priority should be given to the rehabilitation of the cocoa sector and to projects which have the possibility of utilizing domestic resources. In this regard, the staff was encouraged by the authorities' efforts to seek foreign technical assistance for the rehabilitation of the cocoa sector, inviting the participation of foreign private firms in the capital and management of some of the plantations. A substantial exchange rate adjustment would also be needed to support this effort; it would provide the local currency resources for an increase in producer prices to the plantations and an increase in incentives to the workers. Of course these incentives would need to be accompanied by additional technical and managerial training as well as by organizational reforms to improve the efficiency of the plantations and the other public enterprises.

An appropriate exchange rate adjustment would also help correct the distortion in relative prices of domestic and imported goods, but would need to be accompanied by restrictive fiscal and monetary policies aimed at cutting back domestic demand. The authorities should also allow the price mechanism to play a larger role in allocating resources, and should be ready to pass through fully to final users the price increases resulting from the devaluation. Consideration should be given to narrowing the use of subsidies to only three or four essential imported food items; the subsidies on other products, especially imported petroleum, should be progressively phased out. The distribution of food aid should also be affected through market-related pricing policies.

A further aim of economic policy--with important medium- and long-term ramifications--should be the mobilization of domestic savings for investment and export and import-substituting activity, including expanded food production. The large buildup of the public's currency holdings over recent years suggests itself as an important initial source for such a mobilization. In this respect, a more active interest rate policy would play an important role by attracting idle money balances toward productive forms of economic activity. Fiscal policy--or, more broadly, economic management in the whole public sector--should place much greater emphasis on efficiency criteria and show less disposition than in the past to delay needed adjustments by resort to various forms of subsidization. The large losses of the enterprises diminish not only the scope for a flexible fiscal policy but also cut back on the pool of savings critical for the restructuring effort. These considerations emphasize the coordinated role which must be played by the various policy instruments if economic objectives are to have hope of fulfillment.

The rapid growth in the external debt and in the debt service burden is a major concern. The staff welcomes the fact that external payments arrears to Fund members have been eliminated and recommends that the authorities eliminate the remaining outstanding payments arrears through rescheduling and seek as well to reschedule bilateral loans falling due in the medium term. These gains should be consolidated by restricting future borrowing to only highly productive investments, leaving infrastructure to be financed with concessional aid.

The restrictive exchange and trade system has been designed to facilitate the central administration of the country's planned economy. Except for the bilateral payments arrangement with Cape Verde, the restrictive exchange measures are being maintained under Article XIV and, therefore, they do not require Fund approval under Article VIII. Nevertheless, on grounds of allocative efficiency, the authorities should administer the quantitative limits and controls as flexibly as possible. As part of the package of recommended policies to improve the external payments position, the authorities should commence liberalizing the restrictive exchange and trade system.

A critical ingredient in the Government's ability to formulate and to monitor the implementation of the suggested adjustment policies would be the availability of current economic and financial data. In the staff's view, the authorities should assign very high priority to correcting the deficiencies in this area. To this end, the authorities should take advantage of the technical assistance available from the Fund and the World Bank, as well as from other multilateral and bilateral sources.

## VI. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision relating to exchange measures of the Democratic Republic of São Tomé and Principe subject to Article VIII, Section 2, and in concluding the 1984 Article XIV Consultation with the Democratic Republic of São Tomé and Principe, in the light of the 1984 Article IV Consultation with the Democratic Republic of São Tomé and Principe conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Democratic Republic of São Tomé and Principe has continued to maintain restrictions on payments and transfers for current international transactions. The Fund encourages the authorities to apply these measures flexibly and to commence liberalizing them. The Democratic Republic of São Tomé and Principe maintains a bilateral payments arrangement with a Fund member; the Fund urges the authorities to terminate this arrangement as soon as possible.

## Sao Tomé and Principe - Relations with the Fund and World Bank

(As of September 30, 1984)

(Amounts in millions of SDRs, unless otherwise indicated)

### I. Relations with the Fund

#### A. Membership Status

| | |
|---|---|
| (a) Date of membership | September 27, 1977 |
| (b) Status | Article XIV |

#### B. Financial Relations

i. General Department (General Resources Account)

| | |
|---|---|
| (a) Quota | 4.0 million |
| (b) Total Fund holdings of members' currency | 4.0 million (100.0 percent of quota) |
| (c) Reserve tranche position | None |

| | |
|---|---|
| ii. Stand-by or Extended Arrangment and Special Facilities | Country has not used Fund resources to date |

iii. SDR Department

| | |
|---|---|
| (a) Net cumulative allocation | 0.62 million |
| (b) Holdings | 0.09 million (14.90 percent of net cumulative allocation) |

| | |
|---|---|
| iv. Administered Accounts | None |

## C. Nonfinancial Relations

i. Exchange Rate Arrangement

| | |
|---|---|
| Intervention currency and the rate | U.S. dollar; Db 1 = US$0.0221 |
| Local currency/SDR equivalent | SDR 1 = Db 45.25 |

ii. Last Article IV Consultation

The last Article IV consultation discussions with Sao Tomé and Principe were held in Sao Tomé during the period March 25-April 9, 1982. The Staff Report (SM/82/102) and the paper on Recent Economic Developments (SM/82/109) were discussed by the Executive Board on October 27, 1982. The decision adopted was as follows:

1. The Fund takes this decision in concluding the 1982 Article XIV consultation with the Democratic Republic of Sao Tomé and Principe, in the light of the 1982 Article IV consultation with the Democratic Republic of Sao Tomé and Principe conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Within the context of a centrally planned economy, the Democratic Republic of Sao Tomé and Principe has continued to apply limits and controls on payments and transfers for current international transactions. The Fund underlines the importance of applying these measures flexibly.

iii. Technical Assistance

During the period August 19-28, 1982 a staff member of the Bureau of Statistics visited Sao Tomé and Principe to examine the collection, compilation and publication of key economic data, and to provide assistance in the preparation of a Central Bank Bulletin.

## II. Relations with the World Bank Group

Since becoming a member of the Bank in 1977, Sao Tomé and Principe has received only two advances for project preparation; the first, in 1981, for US$0.3 million, to finance the preparation of a power project and the second in 1984, for the same amount, to finance the preparation of a cocoa rehabilitation project. For the lending period 1983-87, the Bank staff is currently preparing two credits totaling US$12.0 million, both of which are expected to be approved in Fiscal Year 1985. The first of these two credits consists of an emergency line of credit of US$5 million for small investments, and the second will be a credit of US$7 million to finance a cocoa rehabilitation project.

A general economic mission visited Sao Tomé in January 1984. The mission's Country Economic Memorandum would be the first such report on Sao Tomé and Principe to be formally circulated to the Bank's Board.

## SAO TOME AND PRINCIPE - Basic Data

| | |
|---|---|
| Area: | 964 square kilometers |
| Population: Total (1983) | 102,500 |
| Growth rate | 3.0 percent |
| GDP per capita (1983) | SDR 300 |

| | 1981 | 1982 | 1983 | 1984 Staff Forecast |
|---|---|---|---|---|
| **Gross domestic product and expenditure in current prices** | (In millions of dobras) | | | |
| GDP | 1,285 | 1,316 | 1,387 | 1,460 |
| Agriculture, forestry, livestock and fishing | 376 | 339 | 401 | 432 |
| Manufacturing | 55 | 37 | 25 | 30 |
| Commerce, and other services | 124 | 150 | 232 | 210 |
| Other | 730 | 790 | 729 | 788 |
| Gross domestic expenditure | 2,047 | 2,387 | 2,017 | 2,460 |
| Consumption | 1,709 | 1,610 | 1,694 | 1,675 |
| Private consumption | 1,226 | 1,072 | 1,065 | 1,005 |
| Public consumption | 483 | 538 | 629 | 670 |
| Gross capital formation | 338 | 777 | 323 | 785 |
| Resource gap | -762 | -1,071 | -630 | -1,000 |
| **Government finance** | | | | |
| Total receipts | 644.4 | 537.4 | 518.2 | 600.0 |
| Total expenditures | 854.2 | 1,345.5 | 1,087.7 | 1,635.0 |
| Of which: investment | 338.4 | 755.0 | 323.1 | 785.0 |
| Extrabudgetary accounts (net) | -48.8 | 79.8 | -227.8 | -115.0 |
| Overall government balance | -258.6 | -728.3 | -797.3 | -1,150.0 |
| Financing (net) | | | | |
| Monetary authorities | 104.3 | 262.9 | 442.0 | 450.0 |
| Foreign borrowing | 58.2 | 387.1 | 175.6 | 635.0 |
| Other | 96.1 | 78.3 | 179.7 | 65.0 |
| **Money and credit** | (Percent change) | | | |
| Domestic credit | 67.0 | 38.4 | 20.6 | 35.8 |
| Government | 12.4 | 35.7 | 93.5 | ... |
| Public enterprises | 26.6 | 7.5 | -6.3 | ... |
| Private sector | 1.5 | 72.1 | 22.4 | ... |
| Money and quasi-money | 5.2 | 13.4 | 32.8 | 30.0 |

SAO TOME AND PRINCIPE - Basic Data (concluded)

| | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|
| Balance of payments | (In millions of SDRs) | | | |
| Exports, f.o.b. | 6.1 | 8.0 | 8.1 | 13.9 |
| Imports, f.o.b. | 18.7 | 24.4 | 16.5 | 27.8 |
| Trade balance | -12.6 | -16.4 | -8.4 | -13.9 |
| Services, income and transfers (net) | -2.8 | -6.2 | 0.1 | -4.5 |
| *Current account balance* | -15.4 | -22.6 | -8.3 | -18.4 |
| Long- and medium-term capital | 1.7 | 13.2 | 2.9 | 12.9 |
| Short-term capital including errors and omissions | 1.5 | 6.1 | 1.3 | -2.1 |
| Allocation of SDRs | 0.2 | -- | -- | -- |
| Overall balance | -12.0 | -3.3 | -4.1 | -7.6 |
| Financing | 12.0 | 3.3 | 4.1 | 7.6 |
| Change in net foreign assets | 3.5 | 3.7 | 2.0 | 7.1 |
| Change in arrears | 8.6 | -0.4 | 2.1 | -4.7 |
| Debt rescheduling | -- | -- | -- | 5.2 |
| Gross official foreign reserves (end of period) | 11.8 | 9.2 | 7.1 | -- |
| In months of next year's imports | 5.8 | 6.7 | 3.0 | -- |
| External public debt | | | | |
| Outstanding (disbursed) | 17.5 | 32.7 | 36.6 | 54.6 |
| Debt service (as percent of exports of goods and non-factor services) | 6.3 | 19.5 | 22.6 | 30.2 |