DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

SM/84/225
Correction 1

CONTAINS CONFIDENTIAL INFORMATION

October 22, 1984

To: Members of the Executive Board

From: The Secretary

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

The following corrections have been made in SM/84/225 (10/12/84):

Page 14, last para., lines 3 and 4, and page 15, line 1: add after Cape Verde: "and the recently intensified restrictions on foreign exchange for travel and medical expenses,"

Corrected pages are attached.

Att: (2)

Other Distribution:
Department Heads

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, and the recently intensified restrictions on foreign exchange for travel and medical expenses, 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 Sao 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 Sao 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 Sao 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.