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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 08/53-3

2:30 p.m., June 18, 2008

3. Democratic Republic of São Tomé and Príncipe —2008 Article IV Consultation and Sixth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Request for Waivers of Performance Criteria

Documents: EBS/08/64 and Supplement 1 and Supplement 2 and Supplement 3; SM/08/160

Staff: Wang, AFR; Brown, PDR

Length: 30 minutes

Executive Board Attendance

M. Portugal, Acting Chair

Executive Directors	Alternate Executive Directors
	S. Itam (AE)
L. Rutayisire (AF)	K. Assimaidou (AF)
	V. De la Barra (AG), Temporary
	S. Na (AU), Temporary
	S. Polak (BE), Temporary
	H. Mori (BR), Temporary
	Y. Liu (CC), Temporary
	L. Jimenez (CE), Temporary
	S. Ladd (CO), Temporary
	A. Lahreche (FF), Temporary
	C. Brinkmann (GR), Temporary
	P. Ray (IN), Temporary
	J. Cardoso (IT), Temporary
	H.Yamaoka (JA)
	M. Nozaki (JA), Temporary
	A. Monajemi (MD), Temporary
	A. El-Ganainy (MI), Temporary
	S. Cerovic (NE), Temporary
	D. Abazorius (NO), Temporary
	Y. Ustyugova (RU), Temporary
	S. Alnefaee (SA), Temporary
	C. Sucharitakul (ST)
	N. Raman (ST), Temporary
	D. Muradnazarov (SZ), Temporary
	S. Lin (UA), Temporary
	V. Pillai (UK), Temporary

B. Esdar, Acting Secretary
P. J. Walker, Assistant

Also Present
IBRD: E. Bell, K. Hollifield, L. Razafimandimby. African Department: M. Atingi-Ego, N. Farhan, C. Fernandez, R. Sharer, M. Takebe, J-Y. Wang. External Relations Department: N. Bunemann. Legal Department: B. Steinki. Office of the Managing Director: G. Schwartz. Policy Development and Review Department: S. Brown. Secretary's Department: A. Blazejewski, P. Gotur. Senior Advisors to Executive Directors: A. Ndyeshobola (AE). Advisors to Executive Directors: T. Nguema-Affane (AF), F. Waqabaca (ST).

3. DEMOCRATIC REPUBLIC OF SÃO TOMÉ AND PRÍNCIPE —2008 ARTICLE IV CONSULTATION AND SIXTH REVIEW UNDER THE THREE-YEAR ARRANGEMENT UNDER THE POVERTY REDUCTION AND GROWTH FACILITY, AND REQUEST FOR WAIVERS OF PERFORMANCE CRITERIA

Mr. Rutayisire submitted the following statement:

On behalf of my São Tomé and Príncipe authorities, I would like to thank the Board, Management and Staff for their continued support and useful advice to São Tomé and Príncipe. My authorities are grateful to the international community for their continued assistance to São Tomé and Príncipe.

Recent Developments

As expected at the time of the fifth review, economic activity has been robust in 2007, with a real GDP growth estimated at 6 percent, mainly driven by tourism-related construction, communication, and other services. Cocoa exports, the main exports, increased owing to both higher international prices and increased export volume.

After declining to 14 percent in June 2007, inflation reaccelerated in the second half of the year to reach 27.6 percent at end-December 2007 and 34 percent in March 2008, due to a combination of factors including higher fuel and food prices, depreciation of the dobra, and higher-than-programmed liquidity growth.

In the fiscal sector, higher income tax receipts and increased tax arrears collection boosted revenue performance over the program objective by 1.2 percent of GDP. Expenditures also increased higher than programmed on account of higher utilities, transfers and medical expenses. A significant part of utility payments to EMAE, the state-owned electricity and water company, was to mitigate the impact of the sharp utility tariff hike (40-60 percent) on the population. It is also worth noting that in light of continued increase in international fuel prices, the prices of domestic petroleum products were also increased by 14-25 percent in order to reduce implicit subsidies. In addition, capital expenditure has been cut in order to accommodate the increase in other expenditure items. Despite the mitigating measures taken, the net effect has been a higher-than-programmed domestic primary deficit, which has been financed by drawdown of government deposits.

The authorities made further progress toward a fully integrated computerized public financial management system (eSAFE) by issuing an administrative decree establishing an IT office and a Directorate of Accounting, and issuing a tender for the procurement of IT equipment for upgrading SAFINHO. They submitted to the Parliament a direct taxation reform that will help broaden the tax base, reduce distortions and increase revenue buoyancy over time. To ensure that revenue collections are improved, the authorities have intensified their effort to strengthen tax and customs administration, with notably the assistance of the U.S. Millennium Challenge Corporation (MCC). The budget for 2008, which is consistent with the program and the Poverty Reduction Strategy, has been approved in May 2008.

In the monetary sector, base money grew much faster than programmed and net international reserves exceeded the program target by a large margin, as result of a partial sterilization of budgetary use of oil bonuses and donor grants, in a context of market-determined exchange rate. In light of the inflation developments, the central bank (BCSTP) has increased its use of foreign exchange sales since March 2008 to mop up excess liquidity. Since then, base money growth decreased from 50 percent in December 2007 to 27 percent in March 2008. On the financial sector reform, the central bank (BCSTP) issued the new regulations on capital adequacy, internal control and auditing, bank financial reporting, and credit to employees. In April 2008, the National Assembly (NA) gave its final approval to the anti-money laundering (AML/CFT) law, paving the way for an operational AML/CFT regime in Sao Tome and Principe.

On structural reforms, the government has prepared and submitted to the National Assembly numerous legislations aimed at reducing the cost of investing and doing business in Sao Tome and Principe, and is awaiting their approval by Parliament. These legislations include a new investment code that will provide equal treatment to foreign and domestic investors, a revised labor code that will increase labor flexibility, and a draft legislation, prepared in consultation with the private sector, to reduce impediments to start a business.

Progress has also been made in the implementation of the institutional framework of the oil sector. To lay ground for launching licensing for the Exclusive Economic Zone (EEZ), the National Oil Agency (NOA) prepared a Petroleum Sector Strategy and related laws –the framework law on oil-related activities, the taxation law, and the production sharing contract model– and submitted them to the National Assembly for approval.

Economic Policies for the Rest of 2008

My authorities remain committed to strengthening policy implementation, particularly in containing domestic primary expenditure and in curtailing liquidity growth in order to bring inflation to a downward path. In this regard, policies for the rest of this year will ensure sound management of oil-related and debt relief resources, and lay the groundwork for sustained private sector-led growth. The objectives of the program are to maintain real GDP growth at 6 percent, reduce annual inflation from its current level 34 percent to 13-15 percent by the end of the year, and safeguard international reserves equivalent to 4 months of imports.

Fiscal policy

In the fiscal sector, the objective is to reduce further the domestic primary deficit to 5.2 percent of GDP in 2008, through fiscal consolidation. Specifically, expenditures will be contained through strict quarterly limits on nonessential current spending, particularly on goods and services, strict controls of personnel cost to ensure that the wage bill-to-GDP ratio does not increase, and a reassessment of transfer to the Joint Development Authority (JDA), taking into account budget constraints, oil revenue prospects, and the execution of the JDA budget. My authorities intend to assist the most vulnerable segments of the population through better implementation of HIPC-related expenditure program and a temporary, targeted scheme that will facilitate adjustment to higher import prices for food and fuel. They will continue to improve the execution of public investments projects. In particular, they work closely with external development partners to accelerate implementation of foreign-funded projects, while ensuring adequate resources for domestically-funded investment projects. The projected deficit will be financed in part by the use of IDA's Development Policy Operation (DPO) grant of US$4.5 million and by statutory drawings from the NOA.

Fiscal reforms will essentially continue to focus on strengthening tax and customs management and public expenditure management. In particular, a comprehensive wage study will be undertaken as part of the DPO-supported program with a view to revising the salary structure with improved incentives for civil servants, and thereby avoiding the recourse to ad hoc increases in wages. In order to strengthen the monitoring and execution of the 2008 budget, including the use of debt relief resources, my authorities will continue to upgrade SAFINHO and turn it into a fully fledged eSAFE system incorporating all public accounts, with the assistance from multilateral and bilateral donors.

My authorities are cognizant of the uncertainty regarding future receipts of oil bonuses. Accordingly, they will continue to make good use of donor budgetary assistance and the remaining oil bonuses to maintain fiscal sustainability in the next several years. They stand ready to revise their fiscal program, if the prospects in the oil sector do not materialize as expected.

Monetary, exchange rate and financial policies

The central bank will pursue a tighter monetary policy to complement fiscal consolidation efforts in order to achieve the inflation objective for 2008. The monetary program aims to keep the base money growth on a declining trend. To this end, given the limited effectiveness of interest rates and other monetary policy instruments, the central bank will continue to use foreign exchange sales to mop up liquidity, consistent with the NIR objective. The central bank and the treasury department of the ministry of planning and finance will strengthen their cooperation, through regular information-sharing, to ensure that the BCSTP takes timely action to sterilize budgetary use of oil bonuses, donor funds and HIPC and MDRI savings. To help the liquidity forecast, the BCSTP will use the weekly average, rather than the monthly average, in measuring commercial banks' compliance with the minimum reserve requirements.

The central bank is committed to deepening foreign exchange market reform and complying with obligations under Article VIII, Sections 2(a), 3, and 4 of the IMF's Articles of Agreement. In this regard, the new investment code, which foresees, among others, the elimination of exchange restriction on transfer abroad of dividends is yet to be approved by the National Assembly. To remove the remaining multiple currency practices, the BCSTP will consider revising the mechanism for setting the daily official exchange rate, which will ensure that the spread between the official and commercial exchange rates will not exceed 2 percent. The BCSTP will continue implementing the current policies of holding regular foreign exchange auctions and progressively expanding the foreign exchange auction market to ensure a fuller and faster market determination of the exchange rate.

The central bank intends to continue with its communication strategy of informing the market of its monetary and exchange policies through regular meetings with the banking community and the media, and the posting of various monetary data and financial statements on the central bank's website.

Regarding the financial sector reform, the BCSTP intends to further strengthen the requirements for issuing bank licenses, including by raising the minimum capital requirement. The central bank also intends to enhance its banking supervision. In this regard, with IMF technical assistance, it will further strengthen its capacity to enforce banking supervision regulations through training, implementing the new charts of accounts and quarterly financial reporting by banks and setting up a central credit unit to facilitate information sharing among banks.

Other issues

My authorities remain determined to enhance the investment climate through regulatory reform and upgrading infrastructure. They are hopeful that the completion of abovementioned reforms in the fiscal, monetary and financial sectors and the approval of business-related legislations will significantly improve the business climate and will contribute to the development of the private sector. They will work closely with donors to press ahead with reforms in key areas such agriculture, transportation and energy.

They will also proceed with the reform of public enterprises to improve their financial situation.

As regards debt management, my authorities will continue to ensure debt sustainability after HIPC and MDRI debt relief by refraining from new external borrowing, particularly on commercial terms, and redouble their efforts to seek full delivery of HIPC debt relief from the remaining official creditors.

Conclusion

Overall, performance under the program in 2007 has been broadly satisfactory, despite that two quantitative performance criteria at end-December 2007 on the fiscal primary balance and net credit to the government have not been observed and the structural performance criterion on public financial management reform was met with delay. In light of the remedial actions taken and the policy commitments for the remainder of the program, my authorities are requesting Board approval for the requested waivers and the completion of the sixth and final review of the PRGF-supported program.

Mr. Gakunu and Mr. Ndyeshobola submitted the following statement:

We are grateful to staff for the clear and concise set of documents and to Mr. Rutayisire for the informative Buff statement. We commend the authorities in Sao Tome and Principe for the continued impressive performance of the economy despite the adverse external environment. While real GDP growth has been robust at 6 percent on average for three years in a row, led by construction and services, inflationary pressures have picked up since 2007 owing to rising food and oil prices, and fiscal overruns. We note that due to the significance of the food and oil price shocks, the risks remain on the up-side in the near term. We welcome the authorities' continued efforts and firm commitment to implement the program, with all but two quantitative and one structural performance criteria for December 2007 being met. Going forward, critical challenges remain, in particular those relating to fiscal sustainability, external stability and structural reforms on which we focus our observations for emphasis. Given the authorities' commitment to strengthened implementation of policy reforms under the program, we support the completion of the sixth review of the three-year PRGF program and the associated waivers.

Fiscal sustainability

While we are in broad agreement with the thrust of the staff appraisal over the challenges underlying the country's fiscal sustainability, we are reassured by the authorities' commitment to substantially reduce the fiscal deficit from 8.1 percent of GDP in 2007 to 5.2 percent of GDP this year. We note, however, that as a result of the need to mitigate the impact of high import prices for food and petroleum products, the fiscal deficit will remain slightly higher than the target of 4.8 percent of GDP. The authorities' commitment to implement measures to improve revenue collection—in particular the broadening of the tax base, reform of direct tax structure, reduction of tax distortions, and collection of tax arrears—is encouraging.

We consider the authorities' fiscal consolidation through expenditure reform to be in the right direction. To this end, we welcome the convergence of strategy between the authorities and staff for further fiscal consolidation, and encourage the authorities to steadfastly strengthen control of non-wage recurrent expenditure and the envisaged public sector wage reform. We also see merit in further aligning budgetary allocations with the Priority Action Plan of the PRSP so as to help mitigate the impact of the recent external shocks on the vulnerable communities.

External stability

We concur with the staff assessment that the key challenges facing the authorities on the country's external stability are symptomatic of a small, island and resource constrained economy, namely the weak export base, high import dependence and high vulnerability to adverse external shocks. In view of the country's very small domestic market and a low saving rate, we concur with staff's recommendations on the policy thrust to reduce the country's vulnerability. To this end, we encourage the authorities to aggressively pursue the improvement of the business and investment climate and the regulatory support to private sector development, the upgrading of infrastructure, improving access to financing, and developing agriculture and other sectors to help broaden the economic base and export capacity.

On the country's underlying vulnerability to debt stress, we see merit in the authorities' response strategy to mobilize non-debt creating external financing, attract foreign direct investment and donor grants, and to seek full delivery of HIPC relief from the remaining creditors. We also welcome the authorities' commitment to strengthen implementation of related policy frameworks aimed at deepening the foreign exchange market reform, removing all multiple currency practices and restrictions, and restoring financial stability going forward.

Structural reforms

The authorities' strategy outlined earlier to develop and broaden the country's productive base as a means of sustaining growth and reducing external vulnerability is appropriate. This strategy is supplemented by the concerted efforts to explore the fossil fuel resource potential. Progress made in upgrading public financial management, completing revision of the commercial code, and adopting a Petroleum Sector Strategy and the related laws are encouraging. On the financial sector reform we urge the authorities to pursue further the strengthening of the regulatory framework and the BCSTP's implementation capacity, the operationalization of the recently enacted AML/CFT regime to reduce the risk of money laundering and bank stress, and the tightening of the requirements for issuing new bank licenses. We also encourage the authorities to make progress under the EITI to increase the transparency and accountability of oil-related resource management.

Wishing the authorities success in meeting their challenges, we support the completion of the sixth review under the PRGF-supported program and the associated waivers.

Mr. Fried and Mr. Ladd submitted the following statement:

We thank the staff for a well-written report and timely Selected Issues Papers. We also thank Mr. Rutayisire for his frank Buff statement.

Although recent performance under the program has not been as good as the excellent start in 2005 foretold, we can agree to the requested waivers and the completion of the sixth review. Our Chair is particularly sympathetic to the economic challenges of small island states. With their greater vulnerabilities and narrower export bases, they require strong policy anchors and greater than average prudence. We agree with the staff appraisal, and offer the following comments for emphasis.

Monetary Policy

The Selected Issues Paper (pg. 15) shows that the authorities have struggled to control inflation, with less and less success, since 2003. Rising food and fuel import prices and currency depreciation have driven inflation up to 34 percent. This exceeds the inflation rate of São Tomé and Príncipe's neighbors and other comparators, as the staff report shows. Given weak financial intermediation and high currency substitution, reducing excessive liquidity and the base-money growth rate will require fiscal restraint and systematic foreign exchange sales. This will require better fiscal-monetary coordination, as called for in the MEFP, para. 18.

The staff draws only a weak conclusion regarding the level of the real exchange rate ("...does not suggest a significant misalignment...."). In fact, the analysis indicates that the exchange is spot-on its equilibrium level. However, given the data weaknesses, lack of high-frequency statistics and the remaining exchange restrictions, it is not clear how meaningful this analysis is. In any event, we accept the staff's conclusion that a firmly-anchored currency arrangement could be beneficial in this case, provided other policies are consistent and appropriate. The monetary policy machinery and financial market development are not sufficient for proper administration of a flexible exchange rate regime at this time. We also encourage the authorities to move promptly on foreign exchange market reforms (MEFP, para. 19) and to accept Article VIII obligations as soon as possible.

Fiscal Policy

São Tomé and Príncipe face a number of fiscal challenges. It is at high risk of debt distress notwithstanding HIPC and MDRI debt relief. Its primary deficit last year was 1.1 percentage points of GDP higher than programmed. Its domestic revenue effort is low relative to its peers. And finally, last year's general wage increase left the authorities with less fiscal space to respond to the food and fuel crisis this year. We urge the authorities to tighten expenditure control, to increase tax effort and to reduce the primary deficit from 8.1 percent in 2007 to 5.2 percent in 2008, as promised in the MEFP. To deal with the current shock, we favor carefully targeted measures over generalized subsidies, which have proven notoriously difficult to adjust or remove in other small island states.

Structural Policy

It is clear that São Tomé and Príncipe's economic future hinges on diversification of the islands' production and exports. The single most important factor will be the timing and magnitude of oil extraction and in this regard, the authorities' preparations to manage the attendant revenues properly is encouraging. However, if the oil business is not to be an enclave, but rather an opportunity for further diversification, the environment for private-sector investment, both indigenous and foreign, should be further improved. The staff report offers appropriate general advice on the matter, and the authorities are urged to review reliable international indicators of economic competitiveness, from the World Bank and elsewhere.

With this, we wish the authorities the best of luck as they exit their PRGF-supported arrangement with the Fund.

Mr. Murray and Mr. Na submitted the following statement:

We thank staff for a well-focused report and Mr. Rutayisire for his helpful Buff statement.

Since the inception of the PRGF program in August 2005, the authorities have embarked on economic adjustment and reform measures. As a result, the Sao Tome and Principe economy has shown robust economic growth fueled by capital inflows as well as a decrease in primary fiscal deficit with a reduction in the public debt burden, although inflation has accelerated in the second half of 2007. Despite the recent policy slippages, the authorities emphasized their commitment to strengthen policy implementation, particularly in expenditure control, liquidity management and structural reforms during the remainder of the program and beyond. In light of this, and given the remedial measures to achieve the missed criteria, we support the completion of the sixth and final review of the PRGF. We also agree with providing waivers of nonobservance of performance criteria for end-December 2007. Looking forward, we would like to ask staff about the possibility of a post-program after the PRGF program expires, and about the authorities' intention concerning this issue.

In the near term, the recent acceleration in inflation is a matter of urgent concern. We note from the selected issues paper that the average inflation rate in Sao Tomé and Principe (STP)—at around 16 percent between 2003 and 2007—was almost double the regional average of 8.1 percent during the same period. Staff analysis indicates that around half of the recent inflation resulted from external factors, such as the global price hike in food and oil, and a third from domestic policy factors, including high rates of money growth, steep depreciation of the dobra, and expansionary fiscal policy. We suggest the authorities consider this finding in designing the anti-inflation policy mix. On the domestic side, we agree with staff that a prudent fiscal policy, coupled with a proactive monetary policy, is essential in containing liquidity growth and anchoring inflation and depreciation expectations. High priority needs to be attached to better coordination of fiscal and monetary policies for the sustainable reduction in inflation. With regard to the global price hikes in food and oil, we welcome the recent change in fiscal program from implicit general subsidies to temporary and well-targeted assistance to the most vulnerable. We also encourage the authorities to take closer monitoring on the development of price and to work closely with the World Bank to put a well-organized support scheme in place.

It was generally accepted that the key challenges ahead are maintaining fiscal sustainability and developing the domestic production and export base. We note with concern that public expenditures, particularly current spending, have sharply increased by an average of 30 percent per year since 2004, in anticipation of oil revenues, but STP's tax revenue-to-GDP ratio at 16.3 percent in 2007 is rather low compared to neighboring countries in the region. Given uncertain oil prospects and rising demand in investment for economic development and poverty reduction, sustained fiscal consolidation should be the undoubted crucial measure for medium-term macroeconomic stability. The first priority should be to implement belt-tightening measures, centering on initiating wage reform in the context of broader civil service reform, given the expected effect of the 2007 general wage increase. In this regard, we view staff's recommendation of a sustainable reduction in the domestic primary deficit from 8 percent of GDP in 2007 to 3 percent by 2010 as a step in the right direction.

With these remarks, we wish the authorities all the success in their future endeavors.

Mrs. Sucharitakul and Mr. Waqabaca submitted the following statement:

We thank staff for the well-written papers and Mr. Rutayisire for his informative Buff statement. Exposure to external shocks, coupled with a narrow export base, magnifies the challenges and vulnerabilities of small island states like São Tomé and Príncipe. Despite such odds, we commend the authorities for overall satisfactory performance under the PRGF program, resulting in robust economic activity. Real GDP growth in 2007 was high at 6 percent, while inflation declined. However, we are greatly concerned that the rebound in inflation, which surged to 34 percent in March 2008, is far higher than global trends alone would suggest. Whilst the medium term prospects look positive, the authorities need to better manage external shocks and challenges including maintaining financial stability and expanding the production and export base. To improve macroeconomic management and ensure sustainable performance going forward, it is critical for the authorities to strengthen policy implementation, particularly in consolidating expenditure and curtailing liquidity growth in order to control inflation. Given the remedial measures taken and commitment by authorities for the remainder of the program, we support completion of the review and request for waivers of performance criteria.

Containing inflation is the immediate challenge and has been a long standing struggle for the authorities as indicated in the SIP. A combination of factors including higher global commodity prices, depreciation in the exchange rate and excessive liquidity in the system, fuelled inflation. The challenges posed and potential of the accelerating inflation to negatively impact investment, competitiveness and growth makes this a priority. We agree that fiscal and monetary anchors are necessary for sustainable disinflation hence the need for improved coordination between fiscal and monetary policy. Nevertheless, given limited availability of monetary policy instruments for liquidity management as captured in Box 2, fiscal policy needs to play central role to address the inflationary concerns. A further concern on the fiscal front is the medium-term objective to safeguard financial stability in light of the already-high risk of debt distress, despite HIPC and MDRI debt relief and the potential for a large output loss owing to a large negative terms of trade shock.

In light of these urgent challenges, we encourage the authorities to commit to the 2008 budget, which aims to reduce the fiscal deficit to 5.2 percent of GDP from 8.1 percent in 2007. We welcome the efforts to upgrade the SAFINHO into a fully fledged eSAFE system that will enhance budget execution and monitoring, as mentioned in Mr. Rutayisire's statement. On the revenue side, the country's tax revenue-to-GDP ratio of 16.3 percent is considered low compared to neighboring countries in sub-Saharan Africa. Nevertheless such a ratio is very much comparable to that in many of our South East Asian members and we encourage the authorities to further build on this progress with reforms in direct and indirect taxation and customs administration should increase revenue generation needed for development and poverty reduction. On the expenditure side, there is need to strengthen controls. We welcome the commitment by authorities to wage reform as the large increase in personnel costs in 2007 limited the authorities' capacity to maneuver in the face of the global increase in fuel and food prices. We look forward to the outcome of the wage study to revise the salary structure and prevent recourse to ad hoc wage increases. We are reassured by the key measures that the authorities will take to tighten control on non-wage current expenditure and encourage them to press ahead with the measures. The other major component that has driven current expenditure is the impact of rising fuel prices. It is clear that payments to the utility company, EMAE, cannot continue indefinitely in the face of persistent high global energy prices and agree with staff's advice for the authorities to explore more targeted and efficient means of shielding the poor. We would be interested in hearing if the authorities have approached the World Bank, as suggested, and the progress on that front.

While fiscal policy is the key to macroeconomic sustainability, we think monetary policy could help support the adjustment process, particularly in dealing with excess liquidity in the financial system. We commend recent progress by the BCSTP in curbing liquidity growth, primarily through foreign exchange sales. Nevertheless, this is not likely to be a stance the central bank can sustain, given the current level of reserves (about four months of imports). In fact, resorting to large scale sales is likely to put the dobra under pressure, given the large current account deficit. This, in turn, would likely exacerbate the impact of imported inflation. It is important that alternative monetary instruments be developed as a matter of some priority. In particular, we wonder whether reserve requirements could be used in slowing credit growth?

We recognize the need to accelerate structural reforms that are vital to propel businesses by creating a conducive environment which will support private sector led growth. In this regard, a speedy approval by Parliament of the business-related legislations that will reduce the cost of doing business should boost private sector activities. The efforts to reform the financial sector including raising the minimum capital requirement and tightening licensing of banks are welcomed measures. We recognize in this regard Fund assistance to improve supervision of banks. Like staff, we welcome São Tomé and Príncipe's participation in the EITI initiative, and encourage the authorities to increase the transparency and accountability of oil-related resource management.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Prader and Mr. Polak submitted the following statement:

We thank the staff for providing a realistic assessment of the current economic developments in São Tomé and Príncipe and we agree with their appraisal and recommendations. We also appreciate Mr. Rutayisire's informative Buff statement.

The staff has recommended the completion of the Sixth Review of the PRGF and has supported the authorities' request for waivers for the nonobservance of the quantitative criteria and delayed structural performance criterion. We can go along with the staff recommendations. However, we urge the authorities to pursue resolutely the macroeconomic adjustment recommended by the staff and implement the structural reforms.

The economic prospects of São Tomé and Príncipe depend critically on the possible oil exploration. Therefore, we welcome the fact that the Staff Report rightly focuses on the medium-term issues. The authorities have made noteworthy efforts with regard to institutional and structural issues. They should intensify their reform efforts further so that the country is on a sustainable footing regardless of its oil wealth.

It is regrettable that inflation has been the result of loose economic policies, i.e. fiscal expenditure overruns and expansionary money supply. It is important that the authorities exercise prudence when using the oil revenues, especially given the uncertain nature of these revenues which might necessitate a serious tightening in the near future. The authorities should channel the available oil receipts to the production sectors so as to gain from supply side advances and lead to higher growth in the medium term. They should also proceed with measures which will make the functioning of money and foreign exchange markets more efficient.

Given the fact that São Tomé and Príncipe has one of the richest and most unique natural landscapes in Africa, the country could have a competitive advantage in the tourism industry. An oil-driven growth could pose a significant risk to this landscape. Could the staff please comment on how the authorities intend to reconcile these two sectors for the economic future of the country?

Mr. Mori submitted the following statement:

We thank staff for the informative set of papers and Mr. Rutayisire for the helpful Buff statement. We support the completion of the sixth review under the PRGF and the waivers requested by the authorities.

The GDP growth has been maintained at the high rates observed in recent years, but the acceleration of inflation is a concern. The reasons for the hike in prices are a result of the global problem, of higher fuel and food prices, accompanied by a depreciation of exchange rates. Yet, macroeconomic policies seem to have added to price pressures with an expansion of liquidity. As inflation impacts the population differently, affecting more negatively the poorest, adequate macroeconomic policies have to be in place to contain inflation pressures.

Staff prepared a helpful assessment of the possible causes of inflation by applying empirical tests. Despite sub-optimal data set, the conclusion was that increases in international prices of fuel and food products accounted for around 50 percent of total inflation. Domestic factors—represented by dobra base money and the depreciation against the euro—accounted for about 30 percent.

The scheme in which the government has relied on drawing foreign currency deposits for its domestic activities may pose difficulty in managing the domestic demand. The injection of liquidity has to be matched by demand for dobras. Otherwise any excess of liquidity would be translated into demand for domestic goods and foreign currency, both putting pressure on inflation.

The way to control the expansionary effect would be to manage carefully the use of deposits in foreign currency for domestic purposes. Given that such a policy is not always possible in view of domestic needs, a contractionary policy response may be required by the central bank to absorb the excess of liquidity. In the absence of government debt instruments that are the usual way to effect the sterilization, the central bank in São Tomé and Príncipe has relied on the selling of foreign currency for that purpose. Under such a framework, a better coordination between the central bank and the treasury may mitigate the problem. In any event, the reduction in the primary deficit planned by the authorities, especially the efforts to better control expenditure, would be fundamental in the process.

On the other selected issue, we agree that there is a potential for revenue increase in São Tomé and Príncipe, and that such an increase is desirable given the uncertainty regarding the oil income in the near future. In view of the large revenue necessary to address the country’s priority needs to reduce poverty and finance infrastructure, we support all efforts to increase the government revenue.

Nonetheless, the staff seems to exaggerate regarding the country's potential to increase revenue. In Figure 1.2, the performance of São Tomé and Príncipe is in fact lower if compared to the entire sample. Yet, if we exclude the three largest countries in terms of revenue in both comparisons of Selected African Countries and Selected Island Economies, the underperformance seems not to be so large if compared to the average of the remaining countries.

Moreover, the econometric test indicated that the country's potential would be of 37.3 percent of GDP, an overstatement as noted by staff. Yet, the PRSP's target to increase tax revenue to 30 percent of GDP by 2015 would be excessive as well. For a small economy with a very narrow productive base, it would be difficult to extract revenue of such a magnitude. It should also consider the concern that a high tax burden may hamper the efforts to stimulate investment in the private sector. A more realistic number could be worked out to make such a target more achievable.

Ms. Lundsager and Mr. Lin submitted the following statement:

As the staff report notes, performance under the PRGF since the last review has been mixed. Given the importance of fiscal discipline for São Tomé and Príncipe's macroeconomic stability and debt sustainability, we are quite disappointed by the slippage of fiscal policy against the relevant quantitative performance criteria. The authorities have pledged compensatory measures for 2008, but given serious doubts about ownership of reform, we think the more principled approach would have been for the staff to allow this program to expire. We approve the requested waivers with the greatest reluctance.

Consistent with comments made in the context of the implementation plan for IEO review of structural conditionality, the final review of an arrangement offers a useful opportunity for stocktaking, to compare stated program goals with their achievements. Towards this end, the staff's candid assessment of the inconsistent pattern of macroeconomic policies since 2005 is helpful. Could the staff please comment further on overall progress against the original objectives of the program?

In our view, the authorities' overall progress under the PRGF has been modest. The original PRGF request articulated the primary aims of the program as correcting macroeconomic imbalances and creating the conditions for sustained strong growth. While there has been progress on some fronts, significant imbalances persist, and structural reforms have proceeded more slowly than programmed. As a result, the economy is significantly more vulnerable than it would have been if policies—especially usage of oil signature bonuses—had been as prudent as originally envisioned.

Monetary/Exchange rate policy

As was the case at the outset of the program, inflation remains a serious concern. Based on the helpful staff analysis of the most recent increase in headline inflation, we recognize that rapid increases in world prices of food and fuel have played a role. However, growth of the money supply remains high and volatile. While the authorities' compliance with indicative targets for base money growth for March 2008 is welcome, the track record for 2007 and for the program as a whole raises questions about the sustainability of this performance. The authorities have stated the intention to use foreign exchange auctions more actively, and to coordinate fiscal and monetary policies better. We hope that renewed and durable progress along these lines proves our concerns unfounded.

In this particular case—a small, open, low-income economy with a track record of prolonged inflation difficulties—we recognize the potential benefits of monetary union or a hard peg, provided complementary policies and institutions are also put in place. At the same time, the assessment of the equilibrium exchange rate shows that the costs of forgoing nominal exchange rate flexibility are potentially significant. If oil prospects do not materialize, a substantial real exchange rate depreciation will be required. With the burden then falling entirely on price differentials, the adjustment process could be quite difficult. We encourage the staff to keep related issues under close review in the next Article IV consultation.

We agree that prudent fiscal and debt policies are essential complements to a firmly anchored currency arrangement. In our view, the adverse oil sector scenario (as well as the economy's vulnerability to shocks) also underscores the importance of structural reforms to increase labor and product market flexibility and competitiveness.

Fiscal Policy

We are dismayed by the breach of the limit on the primary deficit, because of its size and its potential implications for future fiscal performance. Measures to cushion the effect of utility tariff increases should have been carefully targeted at the most vulnerable groups, rather than general price subsidies. Should similar needs arise in the future, we strongly encourage the authorities to target income support more effectively.

More generally, the most recent fiscal policy slippage reinforces our concern about the consistency and durability of what progress has been made under the program. We welcome the authorities' planned compensatory measures for 2008, as outlined in Mr. Rutayisire's helpful statement. However, we are concerned about the feasibility and sustainability of these adjustments, especially in light of ongoing political uncertainty. For example, containing the growth of the government wage bill would indeed be helpful. However, we must recall that an objective stated in the original PRGF request was the gradual decline of the wage bill (as a share of GDP) from 2006 onward.

Looking ahead, prudent stewardship of remaining oil bonuses, sustainable revenue growth, and expenditure restraint will be essential. Toward those ends, we hope the authorities fully utilize the assistance from the U.S. Millennium Challenge Corporation to strengthen tax and customs administration.

Structural Reform

We welcome recent signs of progress toward more transparent management of oil resources, as described in the staff report. An assessment of overall progress relative to the specific program goals for oil sector governance, as outlined in the original Memorandum of Economic and Financial Policies, would have been particularly helpful. We invite the staff's comment.

Mr. Bakker and Ms. Cerovic submitted the following statement:

We thank the staff for a well-written set of papers and Mr. Rutayisire for his informative Buff statement. São Tomé and Príncipe's economic activity under the PRGF-supported program has been strong. Real GDP growth remained robust, tax revenues exceeded the program targets, and foreign reserves were higher than envisaged. However, accelerating inflation and the overrun of budget expenditures, accompanied by recent political turmoil cast a shadow on these positive developments. Given the authorities' commitment to restoring financial stability, we support completion of the sixth review under the PRGF, and approve the waiver for the non-observance of the end-December performance criteria. We share the thrust of the staff's appraisal and limit our comments to key areas.

In light of the higher than programmed primary fiscal deficit in 2007, strong fiscal consolidation is called for, in order to provide medium-term sustainability. While we understand the recent expenditure increase to mitigate the impact of external shocks, we urge the authorities to tighten the current expenditure control. Uncertainty is still present in oil revenue prospects and envisaged tax reforms need time to affect budget results. It is unfortunate that current expenditures in 2007 crowded out capital expenditure funding. On the revenue side, delays in approving the tax package laws by the National Assembly are worrisome, and staff rightly highlights the importance of their timely implementation. The adoption and implementation of a tax package will help to broaden the tax base and sustain public expenditure.

As in many other countries, developments in global food and fuel prices have led to inflationary pressures in recent months. Nevertheless, as explained in the insightful Selected Issues Paper, domestic policy factors also played a significant role in price developments, accounting for a third of recent inflation. Therefore, an appropriate policy mix and improved coordination of fiscal and monetary policy is crucial to alleviate the inflationary spike. We note that year-on-year inflation is targeted to fall to 13 percent by the end of the year. Given the soaring commodity prices, and with inflation reaching 34 percent in March 2008, we find this target optimistic. Staff's comments are welcome.

Further implementation of structural reforms is key to attracting new investments, increasing private sector activity and expanding the country's production and export base. We therefore encourage the authorities to enact and implement a new investment code and reduce business barriers. Finally, we welcome the recent approval of the anti-money laundering law, and the authorities' intention to proceed quickly with its implementation.

Mr. Bergo and Mr. Abazorius submitted the following statement:

We thank staff for a well-written and comprehensive set of papers, and Mr. Rutayisire for his helpful Buff. The performance under the PRGF-supported program has been mixed, with growth remaining robust while inflation has accelerated and public expenditure overruns markedly up. We appreciate the progress being made regarding structural reform, but more clearly needs to be done to achieve a balanced growth and a reduction in inflation and poverty. We broadly agree with the staff's appraisal, and we will add a few points for emphasis. We also support completion of the review and granting of the waiver.

Debt vulnerability is high. The debt sustainability analysis shows how very dependent Sao Tome and Principe is on future oil production coming on stream. Given the uncertainties we would encourage the authorities to work out a medium-term contingency plan in the event the expected oil income should fail to materialize or be delayed. Strong corrective measures would then be needed and the authorities would probably be well advised to err on the side of caution in their assumptions regarding future oil income. In any event there is a need to strengthen domestic revenue mobilization and to maintain fiscal discipline. Staff 's comments would be welcome.

We can agree to the proposed fiscal program easing to mitigate effects of the increase in energy and food prices on the poorest segments of the population given that this can be financed through World Bank grants. However, there is a clear need for better targeted measures. General subsidies like those made through EMAE are neither efficient nor effective in assisting the poor.

We look forward to the implementation of the fiscal reforms as noted in Mr. Rutayisire's Buff. Prompt implementation could be key to limit inflationary pressures and reduce external vulnerability,

Monetary policy should be tightened to contain inflation. In this respect we take comfort in Mr. Rutayisire's assurance that the monetary program will aim at keeping base money growth on a declining trend. We take note of the authorities' interest in reconsidering the country's monetary and exchange arrangements, but doubt whether it would be appropriate to move to a fixed exchange rate regime in the near future.

We appreciate the authorities' efforts to strengthen management of oil related resources and note that the country is now a candidate state of the Extractive Industries Transparency Institution. We reiterate the importance of developing solid institutions to secure a transparent and effective management of oil revenues.

We stress that the continuation of structural reforms, especially aimed at reducing the cost of doing business in the country, is needed to increase the export base and maintain sustainable growth rates and thus improving the prospects to achieve the MDGs. To complete the revision of the commercial code and streamline business licensing procedures, as well as making them more transparent, are important actions to enhance the business climate and attract private investments. We encourage the authorities to ensure speedy approval of a new income tax law and investment law. We see merit in private partnership in upgrading the utility sector.

Mr. Rojas and Mr. Jiménez submitted the following statement:

We thank staff for a very informative set of papers and Mr. Rutayisire for an insightful Buff statement. Notwithstanding a strong performance in terms of economic activity, we are concerned about the acceleration in inflation (annual inflation reaching 28 percent by the end of 2007), which mainly reflects the external developments in food and fuel prices but also—and more worrisome—the budgetary expenditure overrun.

We agree with the staff in that fiscal policy needs to play a central role in the disinflation process, particularly in face of the monetary policy limitations for liquidity management. Consequently, the deepening and acceleration of the structural reform process is indispensable, and the rationalization of the public service wage and salary structure must indeed be launched as soon as possible. This is also the case of the implementation of the direct taxation reform package after NA approval, which should be done timely although its effects may not be observable in 2008. Moreover, the limitation of nonessential current expenditure is of the utmost importance.

Regarding monetary policy, we are aware of the weak traction of monetary policy instruments and factual limitations for sterilization (unsustainable in the long run). While we realize that the base monetary growth is already on a declining trend, this is not going to be of much use if other mechanisms are not used to mop up liquidity. This is why monetary policy needs to be supported decidedly by fiscal restraint. In the long run, the deepening of the exchange market reform may also help in this regard. We also back the staff suggestion to eliminate the remaining exchange restrictions.

In view of the difficulties for an effective macroeconomic management, structural reforms are even more necessary. Therefore, we are concerned about the slow progress in implementing them in recent years. Not only will they be helpful to improve the macroeconomic framework, but they will also contribute to diversify economic activity, thus enhancing the tax base and reducing external vulnerability. In particular, a deeper public sector reform is essential as this may help to develop the private sector and diversify the supply sector of the economy.

We can go along with the staff recommendations and support the completion of the sixth review under the PRGF and the authorities' request for waivers for the nonobservance of the performance criteria, based on the authorities' remedial actions to contain budgetary expenditure and base money growth, as well as on their policy commitments for the remainder of the program.

With these remarks, we wish authorities every success in their endeavors.

Mr. Yamaoka and Mr. Nozaki submitted the following statement:

We thank the staff for an informative set of papers and Mr. Rutayisire for his comprehensive statement. We welcome the favorable growth record of São Tomé and Príncipe, but are concerned about its very high inflation. Although inflationary pressure stems from a global rise in food and commodity prices, we note that the country's expansionary macroeconomic policy is also responsible. The debt situation is also highly vulnerable, presenting a substantial risk of debt distress despite the HIPC and MDRI debt relief. Against this background, and given the limited effectiveness of monetary policy, we reiterate the importance of conducting a prudent fiscal policy.

Fiscal Risks

We regret the slippage of the fiscal target for 2007, by 1.1 percent of GDP, due to a spending overrun, as this slippage added to the economy's inflationary pressures. Nevertheless, given the difficult situation of the authorities, their commitment to a sizable fiscal tightening in 2008 and the progress in structural reforms, we could go along with the proposed waivers and support the completion of the sixth review. Nonetheless, we urge the authorities to achieve the 2008 fiscal target, and keep up with the steady implementation of structural reforms, especially in the fiscal area.

We note that high fuel prices constitute the major fiscal risk. Unless international petroleum prices are fully passed on to domestic utility prices, fiscal accounts must bear the burden of price differences. If this were to result in a fiscal deficit, it would easily lead to second-round effects and could bring about an inflation spiral. Thus, we agree with the staff that an implicit general subsidy should be replaced with targeted assistance to the poor. We would also like to note that sterilization via foreign exchange sales is not the first and best policy as it reduces international reserves, and that rising food and energy prices further complicate the estimation of an adequate level of international reserves.

Monetary and Exchange Rate Regimes

We welcome the discussion of the appropriate exchange rate regime for the country. In principle, São Tomé and Príncipe may arguably benefit from a strongly anchored fix currency arrangement, especially given the current high euroization and the very limited maneuverability and effectiveness of its monetary policy. In addition, due to the high cost of developing infrastructure for independent monetary policy, it could be easier to "import" the monetary policy of a strong currency.

Nevertheless, the authorities may also want to take into account other factors that do not favor a fixed exchange rate regime. One well known consequence of such a regime is that the nominal exchange rate cannot be used to absorb external shocks, and therefore domestic price levels must adjust in order to correct imbalances. Moreover, monetary authorities cannot control domestic liquidity under the hard peg (e.g., currency board). In fact, the staff shows that domestic liquidity affects inflation, to some extent, and hence would better be kept at bay to achieve low inflation. Therefore, we encourage the staff and the authorities to further deepen their analysis.

Inflation and Macroeconomic Policies

We appreciate the staff's analysis of the "policy mix to achieve price stability", presented in the Selected Issues paper. The staff correctly points out the importance of fiscal tightening to reduce inflation, a conclusion with which we fully agree. Having said that, we have some technical questions regarding the estimation included on page 17 of the Selected Issues paper, as follows.

Especially in the sample period (from 2004 to 2008), the chart on page 16 (Figure II.3.) suggests strong multi-collinearity between money growth and the exchange rate. In addition, oil and food prices, which are both included in the category of international commodity prices, may also correlate with each other. Thus, we would welcome the staff's views on the influences of a possible multi-collinearity among variables in terms of the robustness of the estimation.

Shall the expected coefficient of real economic activity be negative or positive? (It is our guess that the classical "downward-sloping" Phillips curve might suggest a positive coefficient.)

Does the relatively short sample period (from 2004 to February 2008) affect the robustness of the estimation? Are longer time-series data available or not?

Since money variables are strongly affected by the fiscal developments in São Tomé and Príncipe, we feel it is a bit risky to state that "inflation is a monetary phenomenon in STP" based solely on this estimation. If the money variable substantially reflects the development of "hidden" variables such as the government's fiscal stance, domestic inflation might largely reflect other factors such as fiscal factors, rather than genuine monetary factors. We would like to monitor whether the staff's estimation will remain robust, and whether the reduction in money growth will be effective in curving inflation.

We reiterate that we fully concur with the staff's views concerning the importance of conducting prudent fiscal policy. At this juncture, one serious risk to the world economy is that inflation pressures are not sufficiently checked by appropriate tightening policies. Although the increases in oil and food prices are likely to be explained as "exogenous" by each country, from the perspective of the global economy they are endogenous, and thus the Fund is responsible for recommending appropriate macroeconomic policies to maintain price stability over the medium term. In this regard, we truly appreciate the above-mentioned staff analysis, as it provides an informative background to identify appropriate policy recommendations.

With these remarks, we wish the authorities every success in their policy implementation.

Mr. Daïri and Mr. Monajemi submitted the following statement:

We thank staff for a comprehensive set of papers and Mr. Rutayisire for his useful statement. Against the background of significant progress in macroeconomic stabilization and reform over the past two-three years, recent economic performance in Sao Tome and Principe under the PRGF-supported program has been mixed. While economic activity has continued to be robust, inflation has increased as a result of the pass through of increases in the international prices for food and fuel products and a budgetary expenditure overrun. Going forward, we agree with staff that the country's medium-term prospects depend critically on deepening structural reforms, further fiscal consolidation, addressing capacity constraints, and strong donor support. We are in broad agreement with the staff appraisal and support the proposed decision.

The authorities' commitment to tighten the fiscal stance, with wage reform and stronger control on current expenditure, is commendable. The 2008 budget appropriately maintains the momentum of consolidation, with ambitious targets and more efficient prioritization of public investment. Restricting public sector wage increases would create room for spending on social sectors. Mr. Rutayisire indicates that the authorities intend to support the poor through better implementation of HIPC-related expenditure program and a temporary targeted scheme. Staff rightly underscore that the country's fiscal and external financing strategies need to adjust to the uncertain oil revenue. Therefore, as underscored in the Selected Issues paper, efforts should be made to build a solid non-oil revenue base to meet the rising expenditure needs. Given Sao Tome and Principe's low tax revenue-to-GDP ratio, the authorities need to reduce tax exemptions and improve tax and customs administration to increase revenue buoyancy. In this connection, it is encouraging to learn that they are intensifying their effort to strengthen tax and customs administration.

Monetary tightening, together with improving liquidity management, should facilitate disinflation. We agree with staff that prudent fiscal policy would also play a critical role to this end. The agreement between the Treasury and the BCSTP for closer cooperation and the BCSTP's monitoring of the weekly average commercial bank minimum reserve requirement are welcome developments. While the current exchange level seems to be at its equilibrium level, an active monetary policy in the context of a flexible exchange rate regime will help macroeconomic stability.

Ongoing efforts on the structural front are commendable. Particularly noteworthy are the authorities' adherence to the principles of the EITI and efforts for their implementation, revision of the labor code, and the restructuring of the electricity sector. Nevertheless, reinforcement of structural reforms is vital to sustaining high growth to accelerate poverty reduction. The authorities are encouraged to enhance efficiency of the financial system, including through tightening the requirements for issuing new bank licenses.

Further reforms aimed at promoting private sector activity, including developing the agricultural sector and improving infrastructure, are necessary for raising growth and reducing poverty.

The DSA analysis demonstrates that reducing risk of external debt distress hinges on finding commercially extractable oil reserves. Therefore, the importance of prudent fiscal policy and growth-oriented reforms cannot be overemphasized. Moreover, the authorities should rely primarily on grants and concessional borrowing to safeguard debt sustainability and reduce vulnerability to external shocks. Their efforts to seek full delivery of HIPC relief from the remaining creditors and to strengthen their debt management and analysis capacity are encouraging.

Further improvement is needed in the statistical area to address the remaining weaknesses, which would strengthen policy formation, analysis and implementation, and help in monitoring progress toward the Millennium Development Goals.

Mr. Fayolle submitted the following statement:

We thank the staff for an interesting report and the selected issues papers, as well as Mr. Rutayisire for his informative Buff statement. We support the completion of the sixth review under the PRGF arrangement, as well as the request for waivers in light of the remedial measures taken by the authorities and their commitment to the remainder of the program. This is the final review of this program. Therefore, we would have appreciated some further discussion on the nature of the Fund’s future engagement in the country.

Being a very small and open economy, São Tomé and Príncipe is vulnerable to external shocks. Moreover, it has to face a significant amount of uncertainty due to the still unclear prospects of the oil sector. In this context, prudent macro-economic policies are crucial, not only to safeguard and further reinforce the hard-won stabilization brought about by this PRGF but also to increase the benefits of debt-relief from the HIPC/MDRI.

Like in many other countries, São Tomé and Príncipe has been hit by the surge in food and oil prices, and has suffered from spiraling inflation. In this regard, we welcome the adjustment made to the fiscal program to allow for some assistance to the poor and the most vulnerable. However, excessive public spending has also contributed to this outcome and containing further inflationary pressures will be critical going forward. We therefore support the targeted reduction in the primary deficit. This will imply both containing the growth of expenditure and limiting withdrawals from the National Oil Account, as well as increasing revenues. Fiscal revenues are low compared with other countries in the region, and the potential to raise them is significant, as shown in the staff's selected issues papers. We therefore call on the authorities to take into consideration the staff's proposals.

Improvements in liquidity management by the central bank are welcome, and need to be maintained. We, however, agree with the staff's appraisal on the need to maintain a strong coordination of monetary and fiscal policies, in order to ensure consistency of the global macro-economic setting. Furthermore, in order to underpin the external sustainability of the country, we concur with staff that the country should rely solely on non-debt creating external financing and concessional financing.

We commend the authorities for the efforts undertaken to improve the overall transparency and strength of the institutional setting of the country, notably through their candidacy to the EITI and through the adoption of an AML/CFT framework. This is particularly important, as a transparent and well-designed institutional framework is instrumental to enhance the attractiveness of the country for foreign direct investment.

Mr. Sadun and Mr. Cardoso submitted the following statement:

We thank staff for the comprehensive and well-written set of reports and Mr. Rutayisire for the candid and insightful Buff statement, which clearly describes the recent macroeconomic performance and appropriately emphasizes the country's medium-term challenges.

São Tomé and Príncipe is a low-income country, notwithstanding its current transition to an oil-producing economy. As such, it still faces daunting challenges in order to consolidate macroeconomic stability and address pressing social needs. The country's economic future is very much dependent on the outcome of the ongoing exploratory drilling for oil, which has not yet confirmed the existence of commercially extractable reserves. Pending the oil exploration, São Tomé and Príncipe is still highly reliant on aid, given its narrow production and export base.

The two quantitative performance criteria for end-December 2007 on the fiscal primary balance and net credit to the government have not been observed, and the structural performance criterion on public financial management reform was met with delay. Nevertheless, and taking into account the current vicissitudes that the country is facing, we consider São Tomé and Príncipe to have made much progress under the PRGF program. The remedial actions already implemented by the authorities, and the policy commitments for the remainder of the program, made us agree with the requested waivers and the completion of the sixth and final review of the PRGF program.

Notwithstanding the above, we urge the authorities to put forth their best efforts in pursuing sound economic policies, to speed up the reform process so as to facilitate the business climate, and to be prepared for possible disappointing oil revenues. Debt can quickly become unsustainable in a scenario where oil production does not materialize or is substantially lower than expected, without a prudent fiscal policy, efficient debt management, and timely implementation of structural reforms to support broad-based non-oil growth. The Debt Sustainability Analysis update reconfirms that, despite HIPC and MDRI debt relief, São Tomé and Príncipe is vulnerable to adverse external developments, and has a high risk of debt distress. We commend the authorities for the prudent debt policy followed since the reaching of the completion point under the HIPC Initiative, and urge them to make their best efforts in securing the country's financial needs through the attraction of foreign direct investment and donor support whenever possible.

Since the inception of the PRGF program, some significant progress has been achieved, although the current external shocks stemming from rising import prices for food and fuel products have contributed to higher inflation, complicated the reform process, and put an additional pressure on the budget to support the poor. A careful analysis should be focused on the measures that are the most efficient to support the most vulnerable groups.

We note the strengthening of the management of oil-related resources and commend the authorities for the country's having been accepted, in February 2008, as candidate to the Extractive Industries Transparency Initiative (EITI).

To conclude, we urge the authorities to speed up the reform process, and we favor the continuation of the involvement of the international community with São Tomé e Príncipe, where the political environment has been somewhat uncertain recently.

With these remarks, we wish the authorities all the success in their challenging economic reform endeavors.

Mr. Lushin and Ms. Ustyugova submitted the following statement:

We thank the staff for a set of well-written documents and Mr. Rutayisire for his informative Buff statement.

The performance of São Tomé and Príncipe under the PRGF-supported program has deteriorated since the previous review, as evidenced by a number of missed performance criteria. We can go along with the requested waivers only reluctantly and have several questions related to the program implementation. As for the macroeconomic policies for São Tomé and Príncipe, we see merit in the staff recommendations, especially on the policy mix to achieve price stability, and urge the authorities to follow them.

PRGF Implementation

The performance of São Tomé and Príncipe under the PRGF-supported program in July-December 2007 was mixed. Two quantitative performance criteria for the end of December 2007 on the primary fiscal balance and net credit to the government were not observed and the structural performance criterion on the public financial management reform was met with a delay. The authorities request waivers in light of remedial actions taken and the policy commitments for the remainder of the program.

However, the political crisis that unfolded at the end of May, when São Tomé and Príncipe's coalition government lost a parliamentary vote of confidence tabled by the opposition, raises concerns about the status of these commitments. We were also surprised to learn from the news that another election may be announced. The costly elections do not help to address the key problems of the economy - high inflation and a fiscal deficit. Besides, the political instability holds back the structural reforms. According to Table I-2, the implementation of several December 2007 and March-April 2008 benchmarks is still pending.

Therefore, we can only reluctantly go along with the requested waivers. This said, we would like to know how the staff assesses the policy commitments in light of the recent political developments and what the arguments for not letting the program expire were. We would also appreciate more information about the recent economic developments, so as to understand how the commitments taken by the authorities are being implemented.

Economic Policies

The economic activity in São Tomé and Príncipe has recently remained robust. However, the exogenous shocks and fiscal slippages have raised inflation to a record high level of 34 percent in March 2008 and have made it a key challenge. We acknowledge the authorities' intentions to stabilize the situation. In particular, they aim to halve inflation by the end of the year, which is certainly a commendable goal. The question is if it is achievable, given that the dynamics of international prices for fuel and food products explains up to 50 percent of total inflation, while domestic factors account for 30 percent, as described in the SI chapter. Staff comments are welcome.

We urge the authorities to follow the staff's recommendations on the policy mix to achieve price stability, as described in the SI chapter.

On the monetary side, keeping the base money growth on a declining trend is appropriate. But the recent experience demonstrates that monetary policy has not always been adequate in controlling base money growth due to limited instruments for liquidity management, a modest level of foreign currency reserves and inadequate coordination with the Treasury. Improving the coordination between the monetary authorities and the Treasury will certainly help increase the effectiveness of liquidity management via selling foreign currency. However, monetary policy needs to be supported by an appropriate fiscal policy.

Fiscal consolidation is a key component of the disinflation strategy. On the expenditure side, preventing the recurrence of an expenditure overrun is crucial. We encourage the authorities to refrain from any further wage increases before the comprehensive wage study with the support of the World Bank is finished. We welcome the authorities' intentions to tighten control on non-wage current expenditure. At the same time, it is unfortunate that capital spending envisaged for 2008 remains on the declining trend.

On the revenue side, we support the staff's view that the adoption and implementation of a new direct taxation is crucial for the 2008 program, as it would help broaden the tax base and reduce distortions. We are concerned by the declining tax revenue-to-GDP ratio. Therefore, we wonder what the chances are for adopting and implementing the tax reforms in late June, as indicated in Table I-2. What is the estimated revenue impact in the medium term?

Finally, we encourage the authorities to accelerate the implementation of structural reforms aimed at reducing cost of doing business, increasing private sector activity, expanding the export base and attracting new investments on their way to sustained growth and poverty alleviation.

In conclusion, we would like to wish the authorities all the best in their endeavors.

Mr. Rutayisire remarked that, since the constitution of São Tomé and Príncipe provided for the incumbent government to exercise its functions pending the installation of a new government, the authorities' commitment to its relationship with the Fund was not in doubt. Furthermore, the process of putting in place a new government had begun, and was expected to be completed shortly.

The staff representative from the African Department (Mr. Wang), in response to questions and comments from Executive Directors, made the following statement [BASED ON VERBATIM]:

> Directors raised quite a few questions in their grays. Some are of a technical nature, and we will address those questions bilaterally with the relevant Directors after the Board meeting.
>
> Let me turn to the other questions. The first question requested further staff comment on overall progress against the original objectives of the program. The original objective of the arrangement was to create conditions for high and sustainable growth, and to reduce poverty. Over the three years, as illustrated in Figure 2 of the staff report, real GDP growth increased from below 4 percent in 2003-2004 to on average 6 percent in 2005-2007, fueled by capital inflows, both oil bonuses and foreign direct investment. Fiscal imbalances, measured by the domestic primary fiscal deficit since 2004, relative to GDP have been falling. The country managed to reach the completion point under the enhanced HIPC initiative. The public debt burden has been substantially reduced thanks to HIPC and MDRI debt relief.
>
> On structural reforms, the country has made progress in putting in place the institutional framework for transparently managing the existing and

prospective oil resources, as explained in paragraph 11 of the staff report. The framework corresponds to four elements, as highlighted in the original MEFP: the information campaign; the oil sector strategy; the EITI; and the National Oil Agency. However, inflation remained high, in double digits. In a nutshell, important progress has been made, but there are unfinished aspects of the agenda in terms of financial stabilization and structural reform. More needs to be done to create the conditions for sustained growth and poverty reduction.

The second question asked for staff views on the government's policy commitment in light of the recent political change, and wondered why the staff was not letting the program expire. A number of factors have been weighed in the staff's considerations. The first factor is the implementation of corrective measures. Developments through end-March are presented in the staff report. The latest indication we received from the authorities was that base money growth, year-on-year, has continued to fall from 50 percent at end-December 2007, to below 30 percent by end-March, and to about 10 percent by end-May. Net international reserves continued to stay above indicative targets.

Inflation is a concern. Exchange rate depreciation was the main factor driving inflation last year, although from April to May the exchange rate appreciated slightly in response to proactive monetary policy.

The authorities managed to get the 2008 budget passed: the National Assembly adopted the 2008 budget in line with the PRGF-supported program. The National Assembly also adopted the anti-money laundering law in May 2008, which is a significant achievement.

The second factor weighed in our considerations during the staff mission in March. After a period of uncertainty there was a new coalition government, and this new coalition government, for the first time since the 2006 election, has a majority in the National Assembly. This represented a chance to push through some of the difficult reforms that did not take place over the previous two or three years. Have the authorities made progress? As I mentioned, the anti-money laundering law was adopted, the tax package was submitted to the National Assembly, the Urban Property Tax Code was adopted in May 2008, and the 2008 budget was passed.

The last element I would like to mention is structural reforms monitored by the World Bank. A few days ago, on June 10, the World Bank approved disbursement of six million dollars in grants under IDA's Development Policy Operation Facility to São Tomé and Príncipe. Prior to that Board meeting there were nine or ten prior actions in the structural area that were monitored by the World Bank, and which were completed. That is the basis for our recommendation for the review to go ahead.

We discussed with the authorities the possibility of a post-program arrangement, and they expressed interest in a new PRGF arrangement.

On the 2008 program there was a question on the inflation target for end-2008. Let me point out that if the authorities continuously implement fiscal consolidation and monetary policy and reforms as agreed, then the objective would not be unachievable. Achieving this objective is not entirely impossible: the inflation rate was 26 percent by end-August 2006 but under the PRGF it has been reduced to 14 percent by June 2007, so they have done it in the past.

The staff report has provided analysis of the inflation outturn, taking into account domestic policies and external development. The external situation is continuing to change, but it is beyond the authorities' control, including with regard to food and oil prices. As things change during the year, the authorities, with the help of the staff, should revisit the framework.

There was a question on the likelihood of adopting the tax reform package. The Urban Property Tax Law was adopted in early May, but the other laws two—the Personal Income Tax Code and the Property Tax Code—are in front of the National Assembly, pending final approval.

There was a question on whether the authorities have approached the World Bank staff on the social safety net, and I can confirm that they have been talking to each other. As I mentioned, the World Bank Board recently approved the disbursement of six million dollars in grants to support the programs supported by the World Bank.

On monetary policy there is one question on whether reserve requirements could be used in slowing credit growth. The source of liquidity growth in São Tomé and Príncipe is not central bank credit to commercial banks, nor commercial banks' local currency lending. Rather, the source of base money growth is the drawdown of government deposits to finance expenditure, the use of oil bonuses in foreign funding, and donor funding. The right tool to address this is timely sterilization, and the reserve requirement is very high in São Tomé and Príncipe at 24.5 percent.

The last question on structural reform suggests that developing the oil sector could pose a significant risk to the landscape of the country and asks how this reconciles with the development of the tourism sector. Let me clarify that oil exploration developments in São Tomé and Príncipe are all offshore. Onshore production, if any, would be a few years down the road, but the oil sector strategy and the framework law for oil-related activities contains elements on protecting the environment.

Mr. Mori made the following statement [BASED ON VERBATIM]:

I would like to thank Mr. Wang for his answers to the questions, and I would also like to thank the staff for the two good Selected Issues papers. I know that it is difficult to carry out these types of exercises in countries with very little data. In relation to revenue analyses, it is also difficult for more advanced countries, but I think that such exercises are beneficial. It is particularly useful to have a way of analyzing the sources of inflation.

My main comment relates to monetary policy. With higher energy and food prices directly impacting on balance of payments, I am concerned about using international reserves to sterilize liquidity in the economy. This is not only the case for São Tomé and Príncipe, as this problem also applies to other countries as well.

It is possible to find alternative ways to reduce liquidity. I know the authorities are selling foreign currency deposits, but, in addition, a very tight fiscal policy can control government expenditure domestically, although sometimes this is difficult.

Alternatives include utilizing reserve requirements or issuing government bonds, but São Tomé and Príncipe—like many other countries facing similar challenges—needs to find ways to save foreign currency. The current situation of high food and fuel prices is a concern for poor countries that sell foreign exchange reserves to reduce liquidity in the economy.

Mr. Rutayisire made the following statement [BASED ON VERBATIM]:

I would like to thank Directors for their useful comments and advice, which I will faithfully convey to my São Tomé and Príncipe authorities. I would also like to thank the mission chief, Mr. Wang, and his team for their continued excellent work and for comprehensive answers to questions raised by Directors.

Drawing from the discussions, and also from Directors' grays, I have noted with appreciation Directors' recognition of the challenges that a small low-income country with a narrow production and export base such as São Tomé and Príncipe faces, and the efforts that are being made by my authorities to address them and adhere to their program objectives despite an adverse external environment. I thank Directors for the approval of my authorities' request for waivers and the completion of the Sixth Review under the PRGF. That said, I would like to make a few comments for emphasis.

My authorities agree with Directors that, following the recent inflation developments at the end of 2007 and in the first quarter of 2008, and given the country's high exposure to exogenous shocks, there is a need to pursue prudent financial policies going forward to achieve greater macroeconomic stability. To this end, policies for the remainder of 2008 and beyond will be geared towards macroeconomic stabilization through further fiscal consolidation and sound liquidity management.

My authorities also agree with Directors on the need to develop a private sector with a view to broadening the sources of growth and reduce poverty. To this end, they will continue to enhance the business environment through regulatory upgrading infrastructure and the development of key sectors such as agriculture and transportation.

I would also like to reiterate my authorities' appreciation to the international community for its technical and financial assistance. They view this support at a time when they are implementing a wide range of reforms to develop their country as very critical to achieve their long-term growth and poverty reduction objectives. They count on the international community to continue to assist them in their endeavors.

My authorities are aware that the uncertainty about the commercial viability of oil reserves adds to the need for sound fiscal and debt policies, as evidenced by the debt sustainability analysis. They remain committed to the prudent use of external financial assistance and to the pursuit of a prudent borrowing policy in order to maintain debt sustainability. Likewise, they will continue a prudent management of oil bonuses consistent with their fiscal and monetary objectives, and they will also continue to develop the institutional framework for a sound management of oil resources.

The Acting Chair (Mr. Portugal) made the following summing up:

Directors agreed with the thrust of the staff appraisal. They noted that São Tomé and Príncipe's growth performance under the PRGF-supported program has been robust and progress has been made in reducing fiscal imbalances and the public debt burden. However, these favorable developments have been accompanied by accelerating inflation. While surging international prices of food and fuels have contributed to recent higher inflation, public expenditure overruns and weak control of base money growth have also played a role in increasing the pressures on prices and currency depreciation.

Against this background, Directors noted that the main challenges facing the authorities over the medium term are to maintain fiscal sustainability and to develop the economy's production and export base through a deepening of structural reforms. These policies would be particularly important in view of the still unclear prospects for oil revenue and the economy's continuing vulnerability to external shocks.

Directors underscored the need to continue fiscal adjustment and strengthen expenditure control so as to lower inflation and restore financial stability. They supported the authorities' 2008 fiscal program that aims to reduce the domestic primary deficit relative to GDP, introduce direct taxation reform, and provide additional fiscal space to mitigate the impact of rising food and fuel prices on the poor. Directors encouraged the authorities to avoid generalized price subsidies and instead implement targeted assistance to the most vulnerable segments of the population.

Directors supported the efforts of the central bank to improve liquidity management. More active use of foreign exchange auctions to sterilize promptly the budgetary use of oil bonuses and donor funding would help slow base money growth. Directors also emphasized the critical role of fiscal policy in supporting monetary tightening and helping safeguard international reserves.

Directors agreed that maintaining fiscal sustainability in the medium-term will call for enhancing the growth orientation of the budget and bringing recurrent spending—particularly on personnel costs—in line with domestic revenue and available foreign budgetary support. Moreover, to maintain debt sustainability, Directors emphasized the importance of continued efforts by the authorities to strengthen debt management and rely on non-debt-creating inflows and other concessional external financing.

Directors emphasized the need for accelerated structural reform in order to achieve sustained private sector-led growth. In particular, they called on the authorities to significantly improve the investment climate by reducing regulatory impediments to investing and doing business in São Tomé and Príncipe, upgrading infrastructure, and attracting private investment to key economic sectors, especially agriculture. Directors welcomed the progress that the authorities have made in putting in place the legal framework for anti-money laundering and combating the financing of terrorism. Advancing financial sector reform will be crucial to support private sector development. Directors also encouraged the authorities to build on the progress under the Extractive Industries Transparency Initiative, which would further improve the management of oil-related resources.

Directors noted the staff's assessment that the exchange rate in real effective terms does not show a significant misalignment from its equilibrium level. They underscored the importance of deepening foreign exchange market reform. Pressing ahead with measures designed to remove all remaining exchange restrictions would improve the functioning of the foreign exchange market and enable the authorities to accept the obligations under Article VIII of the Fund's Articles of Agreement. Directors supported the authorities' intention to reconsider São Tomé and Príncipe's monetary and exchange arrangements, and noted some possible benefits and limitations of alternative exchange rate regimes. They emphasized, however, that fiscal discipline and prudent debt management are the main prerequisites for any sustainable exchange rate regime.

It is expected that the next Article IV consultation with São Tomé and Príncipe will be held on the 24-month cycle, subject to the provision of the Decision on consultation cycles in program countries.

The Executive Board took the following decision:

Poverty Reduction and Growth Facility—Three-Year Arrangement—Review and Waiver of Performance Criteria

1. The Democratic Republic of São Tomé and Príncipe has consulted with the Fund in accordance with paragraph 4.I.(4)(c) of the three-year arrangement for the Democratic Republic of São Tomé and Príncipe under the Poverty Reduction and Growth Facility (PRGF) (EBS/05/109, Supplement 2, 8/30/05) in order to review program implementation.

2. The letter from the Minister of Planning and Finance and the Acting Governor of the Central Bank of the Democratic Republic of São Tomé and Príncipe dated June 4, 2008 (“the June 2008 Letter”), together with its attached Memorandum of Economic and Financial Policies (“the March 2008 MEFP”) and Technical Memorandum of Understanding (“the March 2008 TMU”), shall be attached to the PRGF arrangement for the Democratic Republic of São Tomé and Príncipe, and the letter from the Prime Minister and Minister of Planning and Finance dated June 30, 2005, as amended, shall be read as further supplemented and modified by the June 2008 Letter together with its attachment.

3. Accordingly, in paragraph 2(f) “SDR 0.423 million shall be replaced by “SDR 0.422 million”, and in paragraph 2(g) “SDR 0.422” shall be replaced by “SDR 0.423”.

4. The Fund decides that the sixth review under the PRGF arrangement for the Democratic Republic of São Tomé and Príncipe is completed and that the Democratic Republic of São Tomé and Príncipe may request the seventh loan in an amount equivalent to SDR 0.423 million, notwithstanding the non-observance of (i) the end- December 2007 quantitative performance criteria on the domestic primary balance and changes in net bank financing of the government set out in paragraphs 4.I.(4)(a)(i) and (ii) of the arrangement, respectively, and (ii) the structural performance criterion related to up-grading the computerized public financial management system set out in Paragraph 4.I.(4)(b) of the arrangement, on the condition that the information provided on performance under these criteria is accurate. (EBS/08/64, 6/4/08)

Decision No. -(08/53), adopted
June 18, 2008

APPROVAL: September 18, 2008

SHAILENDRA J. ANJARIA
Secretary