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**Statement by Mr. Sembene and Mr. Carvalho da Silveira on Democratic Republic of São
Tomé and Príncipe
Executive Board Meeting
July 23, 2018**

On behalf of the Sao Tomean authorities, we would like to express our appreciation to Management and staff for the constructive engagement and policy dialogue during the 2018 Article IV consultation and fifth review under the Extended Credit Facility (ECF). The authorities also welcome Fund's invaluable technical assistance provided over the years. The report provides a candid assessment of the macroeconomic situation, including progress achieved to date as well as challenges and policy priorities for 2018 and beyond.

Noticeable progress has been made in advancing fiscal consolidation and addressing some structural bottlenecks. Still, significant challenges related to the country's state of fragility complicates the achievement of the authorities' targeted development outcomes. These include limited institutional capacity, vulnerability to climate change, and high dependency on external assistance. Nevertheless, the authorities remain committed to addressing these vulnerabilities, notably by pursuing their reform efforts in the context of the ECF-supported program and strengthening capacities with the support of the Fund and other partners.

Performance under the ECF Program

Implementation of the ECF arrangement has recently proceeded in a challenging context. As a result, two out of five performance criteria (PCs) were met, while others related to the Domestic Primary Deficit (DPD) and net bank financing of the central government were missed owing to revenue underperformance, combined with unrealized external budget support and critical spending to address a public health concern. In addition, the PC on net international reserves was unmet due to lower-than-expected external financing. On the structural front, all end-December 2017 and most end-June 2018 benchmarks were met.

The introduction of a central bank's foreign exchange regulation in March 2017 was assessed by staff to have inadvertently led to the breach of the continuous PC against the introduction

or intensification of exchange restrictions. This move was deemed critical for the successful implementation of the authorities' capital account management strategy. Moving forward, the authorities intend to take steps in due course to roll back measures that contribute to exchange restrictions and multiple currency practice, while taking into account the need to maintain external stability.

Recent Economic Development and Outlook

Fiscal tightening and reduced external inflows contributed to holding back economic activity in 2017, with real GDP growth decreasing to 3.9 percent from 4.2 percent in 2016. Cocoa, tourism and construction sectors continue to be the main drivers of the economy. Inflation continued to increase, reaching 7.7 percent at end-2017. The current account deficit worsened due to stronger imports of capital goods and oil products.

Regarding the outlook, staff expects real GDP growth to pick up modestly from about 4 percent in 2018 to around 5 percent in medium term, as key infrastructure projects start to materialize. Inflation is expected to decline this year and remain below 5 percent in the medium term. The authorities concur with staff that the macroeconomic outlook for 2018 and beyond remains positive, but believe the infrastructure projects could lead to a more buoyant near-term prospect. Staff highlights a number of risks to the outlook that could stem from the upcoming elections, delays in donor disbursement, and limited implementation due to capacity constraints. Notwithstanding these uncertainties, the authorities have restated their commitment to steadfastly implement the reform agenda envisaged under the program, as reflected by the implementation of politically difficult prior actions during election year.

Policy Priorities for 2018 and Beyond

Addressing Revenue Shortfall and Contingent Liabilities, and Reduce Debt Burden over the Medium Term

Although revenue outturn was lower than expected, fiscal consolidation efforts have helped to reduce the DPD in 2017. To meet the 2018 fiscal targets and offset the revenue shortfall, the authorities took steps to collect tax arrears owed by large taxpayers. In this respect, fiscal and legal procedures were initiated against the beer manufacturer, Rosema, to resolve tax arrears comprising mainly consumption and personal income taxes that it collected on behalf of the government. As a result of these efforts, staff preliminary assessment suggests that Sao Tome and Principe's end-June 2018 fiscal performance under the ECF arrangement was satisfactory.

Fiscal reforms will be undertaken to support revenue mobilization efforts. In particular, preparatory work will continue for the introduction of the VAT in 2019, with a view to ensuring a smooth transition. Emphasis will be placed notably on facilitating the approval of the VAT Law by the Parliament, harmonizing other tax laws with the VAT Law, securing

appropriate space and equipment, and hiring and training personnel. In line with Fund TA recommendation, a computer-based monitoring system will be implemented for large taxpayers to help boost domestic revenue mobilization. Furthermore, implementation of the automatic price adjustment mechanism led to a rise in domestic pump prices in June 2018 in line with recent international oil price increases.

On the spending front, the focus is put on maintaining fiscal discipline in line with program objectives. This includes streamlining transfers and personnel costs, capping utility consumption of public agencies (including EMAE), containing domestically-financed capital expenditure and freezing real wage growth. If additional resources are available, the authorities are also committed to continuing prioritizing the clearance of arrears to suppliers.

Fiscal risks posed by the public utility company EMAE is still a source of concern for the government. The ongoing reform process should help revamp EMAE's operational efficiency even though it is expected to continue making losses in the medium-term. At the same time, the authorities also expressed concerns over delays in the provision of technical and financial assistance by development partners which have contributed to slowing down some aspects of reform implementation. Going forward, the authorities agree with staff that additional short-term measures to contain costs in SOEs are critical for improving their operational efficiency, and ultimately address the complex web of domestic cross arrears.

The 2018 Debt Sustainability Analysis (DSA) shows that debt ratios have improved but staff highlights the importance of advancing negotiations with external creditors on resolving external arrears. In this connection, the authorities managed to reach an agreement with Brazil which awaiting legislative approval from Brazilian lawmakers, as noted in the staff report. The authorities reiterated their attachment to prudent debt management, as reflected in their intention to limit concessional borrowing. Steps were also taken by the authorities to implement recommendations of the Debt Management Performance Assessment (DeMPA). In this respect, a draft medium-term debt management strategy was prepared; a detailed debt database is being established with the support of the World Bank; and training activities for officials on debt management are being conducted. This work will also be complemented by the dissemination of an annual schedule of T-Bills issuance, aligned with cash flow forecasts and borrowing plans. Going forward, they will continue to make efforts to reach agreement with external creditors on arrears and strengthen their debt management capacity.

Boosting International Reserve Buffers

The authorities take note of staff's assessment that the country's external position is moderately weaker than indicated by fundamentals and desirable policies, and strong reserve buffers are necessary against shocks. To boost reserve buffers, the central bank has started taking steps to strengthen monetary policy tools by amending the regulatory framework to allow the issuance of Treasury Bills and support the development of the securities market. In

the medium-term, continued efforts will be consented to advance structural measures aimed at reducing oil dependence by exploring sources of renewal energy, boosting exports, and improving the implementation of externally funded projects. The authorities will also stand ready to conduct joint efforts with the country's partners to improve the predictability of external assistance.

Safeguarding Financial Stability

The central bank continues to make progress in strengthening banking supervision. In line with staff's recommendation to address the high level of NPLs, a requirement to improve write-offs and recoveries for banks was introduced. Collateral guidelines were enforced while the oversight of the credit risk management framework was improved. In addition, financial sector infrastructure and regulation are being revamped with the support of development partners. This entails notably upgrading the credit registry, infrastructure and laws on payment system, and the microfinance legal framework. Looking ahead, the authorities will continue to implement their financial sector reform agenda while making efforts to accelerate the recommendations of the last safeguards assessment.

Staff's correctly report that preparations for the asset quality review (AQR) of the banking system is advancing—albeit at a slow pace. The authorities noted that factors behind the delays in the procurement process were beyond their control. Going forward, the central bank will continue to liaise with local banks in order to smoothen the process. The full AQR report is expected by mid-2019 and the findings will be used by the central bank to update its loan classification system and strengthen prudential regulations.

Accelerate Growth-Enhancing Projects and Structural Reforms

The authorities acknowledge that continued structural reform efforts are critical to promote sustainable long-term growth, improve competitiveness, strengthen resilience to shocks and address impediments to job creation and investments. They developed the National Development Plan (NDP) for 2017-2021 which highlights the country's development priorities, and focuses on inclusive growth, poverty alleviation and climate change resilience. Most recently, the tourism development strategy focused on export diversification was adopted. In line with staff's recommendation, efforts will be geared at working closely with development partners to accelerate key infrastructure projects, such as the airport expansion, energy grid rehabilitation, and coastal requalification. At the same time, the authorities also envisage some reform measures to address inefficiencies in the judicial system, which should help reduce legal process delays and costs.

Capacity development from partners has been instrumental in helping the country advance their reform agenda. We call on the Fund to take good note of the authorities' strong preference for the assignment of resident and Portuguese-speaking experts in the context of Fund's capacity building initiatives conducted by the Fund for the benefit of their country.

Conclusion

Against a challenging backdrop, the Sao Tomean authorities reiterate their strong commitment to the implementation of their ECF-supported program. Continued engagement and timely delivery of technical and financial assistance from development partners will be critical to safeguarding macroeconomic stability and making headways toward inclusive growth and poverty reduction. In particular, Fund's continued support and catalytic role will be key in achieving these objectives. We would therefore appreciate Directors' support for the completion of the fifth ECF Review as well as the authorities' requests for the approval of waivers for the nonobservance of program targets and the continuous PC related to exchange restrictions.