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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 17/100-2

10:50 a.m., December 11, 2017

**2. Democratic Republic of São Tomé and Príncipe—Third and Fourth Reviews
Under the Extended Credit Facility Arrangement, Extension of the
Arrangement, and Modification of Performance Criteria**

Documents: EBS/17/119 and Correction 1, and Supplement 1, and Supplement 2

Staff: Li, AFR; Fletcher, SPR

Length: 27 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors Alternate Executive Directors

N. Tshazibana (AE)
H. Razafindramanana (AF)
B. Lischinsky (AG), Temporary
G. Johnston (AP)
B. Saraiva (BR)

Z. Jin (CC)

A. Arevalo Arroyo (CE), Temporary
M. Sylvester (CO), Temporary
O. Bayar (EC)
F. Bellocq (FF), Temporary
K. Merk (GR)
M. Roy (IN), Temporary
I. Lopes (IT), Temporary
Y. Saito (JA)
P. Abradu-Otoo (MD), Temporary
F. Al-Kohlany (MI), Temporary
Z. Kalezic (NE), Temporary
E. Anni (NO), Temporary
M. Atamanchuk (RU), Temporary
R. Alkhareif (SA)
C. Ong (ST), Temporary
L. Andresen (SZ), Temporary
J. Stockill (UK), Temporary
S. Sabharwal (US)

H. Al-Atrash, Acting Secretary
S. Kalra, Summing Up Officer
D. Jiang, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present

World Bank Group: R. Barroso, O. Godron. African Department: C. Amo-Yartey, M. Atingi Ego, M. Canales Munoz, M. Dos Santos Martins Francisco, X. Li, D. Robinson, G. Srour. Communications Department: R. Anspach. Finance Department: A. Alsadig. Legal Department: W. Bergthaler, N. Stetsenko, A. Yiadom. Strategy, Policy, and Review Department: L. Antoun de Almeida, K. Fletcher. Alternate Executive Director: M. Raghani

(AF). Senior Advisors to Executive Directors: W. Abdelati (MI), T. Tlelima (AE). Advisors to Executive Directors: E. Boukpepsi (AF), K. Carvalho da Silveira (AF), F. Dogan (EC), S. Fan (CC), G. Khurelbaatar (AP), A. Maciá (BR), H. Mori (JA), F. Rawah (SA), E. Ulo(AG), S. Vitvitsky (US).

2. DEMOCRATIC REPUBLIC OF SÃO TOMÉ AND PRÍNCIPE—THIRD AND FOURTH REVIEWS UNDER THE EXTENDED CREDIT FACILITY ARRANGEMENT, EXTENSION OF THE ARRANGEMENT, AND MODIFICATION OF PERFORMANCE CRITERIA

Mr. Sembene, Mr. Nguema-Affane and Mr. Carvalho da Silveira submitted the following statement:

On behalf of the São Tomean authorities, we would like to thank staff for their candid report and the constructive policy dialogue held with the authorities in the context of the third and fourth ECF reviews. The authorities broadly agree with staff's assessment of macroeconomic challenges and welcome the policy recommendations.

The ECF-supported program has been instrumental in helping São Tome and Principe to maintain macroeconomic stability, unlock financing from other partners, and advance the needed reform agenda amidst decreasing external support, delays in the provision of technical assistance (TA), weak capacities, and high debt levels. While this challenging environment held back the implementation of some reforms, noticeable progress was made to achieve the broad objectives of the program.

Performance under the Program and Recent Economic Developments

Program performance since the last review was solid. All five end-June 2017 performance criteria (PCs) were met, including those related to net international reserves and net bank financing. On the structural front, three end-December 2016 structural benchmarks were implemented, with the aim of strengthening the financial situation of the state-owned electricity and water utilities company (EMAE), and strengthening monetary and financial policy frameworks. However, three were missed, largely because of weak capacities and developments outside the authorities' control. Other structural benchmarks that were missed are still on the authorities' agenda, notably the submission to the National Assembly of draft legislations on a new VAT and the completion of a Public Investment Management Assessment (PIMA). The two end-December 2017 structural benchmark on the submission of a draft public private partnership (PPP) and adoption of measures to contain EMAE's loss in the short-term have now been implemented.

Real GDP recorded another year of growth above 4 percent in 2016, underpinned by strong activity in the cocoa, tourism and construction sectors, and preliminary information indicate that economic activity remained buoyant in the first half of 2017. Inflation rose from 5.1 percent at end-December 2016

to 6.5 percent at end-August 2017, driven by increased prices of locally-produced goods resulting from heavier rainfall. After improving in 2016, the current account deficit widened in the first half of 2017 due to the increased imports of capital goods and oil product and was financed by higher FDI. The external position continues to be adequate with net international reserves at about 3.5 months of imports.

Outlook for the Rest of 2017 and Onwards

São Tome and Principe's near-to-medium term outlook is favorable but remains subject to significant downward risks. GDP growth is projected to continue to grow at around 4 percent in 2017, and this momentum is expected to be maintained in the medium term, boosted by strong activities in construction and tourism, as key infrastructure projects such as the airport expansion and hydroelectric plants come to life. The current account deficit is expected to continue to worsen in 2017 and in the medium term, as FDI related to large infrastructures project are projected to remain high. Inflation would moderate, as inflationary pressures from temporary food shortages fade away. The authorities agree that further delays in external financing and reform implementation due to capacity constraints and the upcoming legislative elections represent major downside risks to the outlook. Going forward, the authorities remain committed to taking necessary actions to enhance economic resilience and maintain the strong growth momentum and appreciate the continued close engagement with the Fund in this regard.

Policy and Reform Agenda

Our São Tomean authorities remain fully committed to the objectives of the ECF-supported program. Going forward, they will focus on ensuring greater fiscal discipline, strengthening the monetary policy framework, safeguarding financial sector stability, and advancing their structural reform program.

Ensuring Fiscal Discipline

After missing end-2016 primary deficit targets, the authorities issued a 2017 revised budget to put fiscal accounts back on track. The corrective measures that were implemented included, among others, (i) spending cuts of 30 percent on fuel by government agencies, except for police, defense and health sectors, and (ii) reduction of 30 percent in salary top-ups and all other benefits at State-Owned Enterprises (SOEs) and autonomous agencies. In addition, an agreement was reached with two large private debtors and a few

SOEs on gradually clearing their tax arrears. As a result, the domestic primary deficit (DPD) target narrowed down to 1.4 percent of GDP in line with the associated target for June 2017. As the outturns at end-August were lower than expected due to unforeseen developments, further measures were identified to close the resulting gap of 2.4 percent of GDP. These include planned arrears collection efforts which will help mobilize about 1 percent of GDP and additional expenditure cuts totaling 1.4 percent of GDP.

São Tome and Principe continues to be assessed at high risk of debt distress. The country's debt to GDP ratio has been revised up due to the inclusion of domestic arrears for the first time. Nevertheless, external debt to GDP ratio is expected to be 46 percent at end 2017, down from 62 percent in 2015-16. The authorities secured an agreement with China involving debt forgiveness for São Tome in the amount of \$18.4 million in pre-HIPIC legacy arrears. They are also working towards reaching a debt rescheduling agreement regarding external arrears accumulated with other creditors. As noted in the report, the authorities also remain fully committed to reducing arrears and concurred to prioritize the payment if additional resources are mobilized. Looking ahead, the authorities reiterate their commitment to avoid accumulation of new arrears in 2017 and limit their external borrowing to concessional loans.

In line with the DPD target of 1 percent of GDP in 2018, the authorities have submitted to the parliament the 2018 budget, which lays out their planned fiscal consolidation efforts. This budget includes both revenue-enhancing and expenditures-controlling measures, including the suspension of the personal income tax credit, wage growth freeze, and constrained hiring in nonpriority sectors.

On structural fiscal reforms, the authorities remain determined to pursue their fiscal consolidation efforts through revenue mobilization. Prompt steps will be taken to finalize the VAT law. In this connection, Fund technical assistance will be critical in setting up a single Tax Authority in the country. The authorities are also making progress in completing the Public Private Partnership (PPP) law which should support efforts in capacity building for efficient public investment decision making. The adoption of the automatic price adjustment mechanism has been serving the country well thus far and should help reduce fiscal risks.

The authorities will pursue the restructuring of the SOEs. In this regard, reforming EMAE is at the top of the authorities' agenda, given the risk it poses to the government finances. As noted in the staff report, major

projects are underway to revamp EMAE in the medium-term, with the assistance of the World Bank and the European Investment Bank. In the short-term, the authorities have taken steps to contain fiscal risks, notably by (i) ensuring ministries and agencies pay electricity bills regularly; (ii) reaching an agreement with consumers with arrears; (iii) enforcing antitheft legislation; (iv) publishing the list of debtors of EMAE; (v) expanding payment of bills through the banking system.

Strengthening the Monetary Policy Framework and Safeguarding Financial Sector Stability

The authorities have been making inroads in improving further the monetary policy framework and securing financial stability in recent years. However, they continue to face a number of challenges, including excess liquidity, anemic credit growth and high levels of NPLs. To address them, the BCSTP is currently working on the amendment of regulations that are required for the operation of a secondary market as well as longer-term instruments, while promoting transparent public reporting of bank's audited financial statements.

On November 2017, the parliament approved the monetary reform law which will allow the redenomination of the currency to become effective on January 1, 2018. The authorities believe that the redenomination of the currency will be an important step toward improving money circulation, streamlining accounting and settlements, maintaining the optimal structure of money denominations, reducing public expenditures on servicing cash circulation, and combating counterfeiting. Preparation for this initiative has begun a while ago and the BCSTP is currently embarked on its final stages, notably by undertaking a number of awareness campaigns.

Financial soundness indicators improved in 2017. The capital adequacy ratio increased well above regulatory requirements, profitability rose, and NPL of banking institutions declined. Notwithstanding these positive developments, the authorities will continue their efforts towards financial sector reforms. To this end, the authorities have recently implemented the Financial Sector Development Implementation Plan, the BCSTP Strategic Plan and the NPL reduction strategy. The Asset Quality Review (AQR) was launched, the risk-based supervision will be revamped with TA from the Fund, and steps are being taken to implement the International Financial Reporting Standards with the support of the Central Bank of Brazil. Progress was also made toward developing an out-of-court settlement mechanism.

The liquidation of Banco Equador is advancing, and the authorities will continue to monitor closely the process notably with a view to containing fiscal risks.

Advancing Other Structural Reforms

The authorities reaffirm their commitment to operationalizing the 2030 Transformation Agenda. In this connection, the National Development Plan (NDP) 2017–2021 was completed and implemented in November 2017 with the support of the UNDP. The plan remains aligned with the sustainable development goals, and focused on accelerating sustainable growth, and strengthening social cohesion and the country's credibility abroad. Moreover, with the support of the World Bank, the authorities are finalizing a national export diversification strategy focused on tourism growth, and taking steps to address the unreliable supply and the high cost of electricity.

Concluding Remarks

Notwithstanding the daunting policy challenges facing the country, the São Tomean authorities have shown a firm commitment to the program by implementing difficult corrective measures to keep the program on track. The Fund continued engagement will act as an important catalyst for other lenders, while providing an appropriate anchor for reforms aimed at achieving macroeconomic stability. The authorities welcome the Fund's valuable technical assistance and look forward to the institution's timely support for their capacity building efforts.

In light of the above, we would greatly appreciate Directors' support for the completion of the third and fourth reviews under the ECF and the authorities' request for extension of the arrangement and modification of performance criteria.

Mr. Merk and Mrs. Suhrcke submitted the following statement:

We thank staff for their insightful report and Mr. Sembene, Mr. Nguema-Affane, and Mr. Carvalho da Silveira for their informative buff statement. We broadly concur with the program assessment and policy recommendations. While São Tome and Principe's macroeconomic outlook is favorable, downside risks to the program remain high and an unwavering commitment to tackle existing challenges such as weaknesses in the banking

sector, threats of further fiscal slippages ahead of legislative elections as well as structural bottlenecks continue to be of the essence going forward.

Regarding program performance, we note with concern the large margins by which the end-2016 fiscal targets were missed but commend the authorities' decisive corrective measures which ensured full compliance with the end-June 2017 performance criteria. Even so, it is regrettable that some structural benchmarks as well as all indicative targets for June 2017 were missed – though by relatively small margins. We encourage the authorities to maintain their vigilance in safeguarding the program objectives and to stand ready to implement further corrective actions if downside risks materialize. Against this backdrop, we can go along with the conclusion of the third and fourth review under the ECF, the extension of the arrangement and the modification of performance criteria. In addition, we would like to make the following comments:

Debt sustainability remains a challenge for São Tome and Principe. To counteract the current “high risk of debt distress” sustained fiscal consolidation, mobilizing additional revenue and improvements in debt management remain critical. We join staff in calling for abstinence from further arrears accumulation and large—even concessional—borrowing. The denomination of a significant portion of domestic arrears in U.S. dollars and considerable contingent liabilities from the state-owned enterprise EMEA are two factors not formally included in the DSA which need to be closely monitored by the authorities.

We reiterate our concern about São Tome and Principe's international reserves position and take note that staff describes it as “robust” while forecasts for international reserves accumulation have once again been revised down for 2017 and 2018 and the PC for end-2017 is proposed to be lowered accordingly. Hence, under the current projection only a very slim reserve accumulation measured in months of imports is foreseen over the remaining course of the program. In the program request 2015 staff candidly pointed out that “5 to 6 months of imports deemed adequate for a small commodity exporting economy with fixed exchange rate regime.” Therefore, we encourage the authorities to step up their efforts to build these adequate buffers.

Considering the country's constrained institutional capacity, technical assistance by the Fund and other development partners and an appropriate sequencing of structural reforms will be prevalent to reap sustainable and growth enhancing results. We concur with staff that future infrastructure

investments need to be efficiently managed and do not endanger debt sustainability. We therefore are looking forward to recommendations from the intended Public Investment Management Assessment (PIMA) and expect authorities and staff to consider them appropriately. Further structural reforms to diversify the export base, improve electricity provisioning and foster the private sector should remain priorities as well.

Mr. Leipold, Mr. Doornbosch, Ms. Collura, Ms. Kalezic and Ms. Lopes submitted the following joint statement:

We thank staff for their report and Mr. Sembene, Mr. Nguema-Affane, and Mr. Carvalho da Silveira for their buff statement. We welcome that program implementation is broadly back on track and support the completion of the third and fourth reviews under the Extended Credit Facility, as well as the suggested modifications to the arrangement. As we broadly share the thrust of the staff appraisal, we would offer just a few comments for emphasis.

We commend the authorities for the adoption of sizeable corrective measures to meet the fiscal targets for end-June 2017 and to correct earlier slippages. We also note that additional measures are envisaged to counter the lower-than-expected tax revenues through end-August, with a view to reaching the program target for 2017 (a primary deficit of 1.8 percent of GDP, corresponding to 2.2 percentage points of adjustment). Actual and forecast growth does not seem to be affected by the extent of this projected fiscal tightening, remaining around 4 percent in 2016-17 and rising to 5.0 percent in 2018. Could staff elaborate on this performance, with any explanation of the implied low multipliers?

The priority of deficit reduction and of addressing fiscal vulnerabilities is also highlighted by the high risk of debt distress evidenced by the updated Debt Sustainability Analysis (DSA), which is based on achievement of the targeted primary deficit in 2017 and its further decrease in the following years. We also note that the DSA does not include arrears of state-owned EMAE to ENCO; these are admittedly outside the current perimeter of public debt and public-guaranteed debt, but could potentially impact debt sustainability. Could staff elaborate on the contingent liability risks of these arrears, and how such risks are being mitigated?

Although some progress in addressing NPLs has been achieved, the financial sector remains vulnerable. We look forward to the conclusion of the Asset Quality Review under way. A steady reduction in NPLs is also dependent on progress in judicial reform. More generally, further structural

reforms remain necessary to improve a still weak business environment and thereby attract foreign investment. FDI inflows are particularly key in a situation in which—as is currently the case for São Tomé and Príncipe—even concessional loans should be avoided given a fragile debt situation, with a high risk of debt distress.

Mr. Gokarn and Mrs. Roy submitted the following statement:

We thank the staff for an informative set of papers and Mr. Sembene, Mr. Nguema-Affane and Mr. Carvalho da Silveira for their insightful buff statement. We broadly agree with the staff appraisal. While São Tome and Principe’s economic issues are defined by its small geographical expanse and natural resource endowments, the ECF-supported program has helped it to maintain macroeconomic stability, unlock financing from other partners, and advance the needed reform agenda. However, it also faces several risks: further delays in external financing and reform implementation due to capacity constraints, high debt levels and the upcoming legislative elections. Mitigating the risks in an import-dependent economy with a production structure dominated by plantations and fishery, reducing poverty rates, maintaining fiscal stability, and encouraging sustainable investment would be helpful for engendering sustainable growth.

After missing the end-2016 fiscal targets by large margins, the government has adopted corrective measures and met all five end-June 2017 performance criteria (PCs). The implementation of structural reforms under the program is progressing, albeit at a much slower pace than anticipated, due mainly to capacity constraints and delays in the delivery of technical assistance (TA). The authorities are requesting waivers for the nonobservance of two end-December 2016 performance criteria regarding domestic primary balance and changes in net bank financing of the central government, on the basis of strong remedial measures implemented, an extension of the ECF program to end-2018, from July 12, 2018, and a rephasing of the final disbursement. In light of the recently-improved program performance, reflecting the authorities’ strong corrective actions, we agree with the staff’s evaluation that the program is broadly back on track following slippages in 2016, and support completion of the joint third and fourth reviews, approval of the extension to end-2018 and rephasing of the program.

Real GDP grew by 4.1 percent in 2016, and is expected to expand at about the same rate of 4 percent in 2017 before increasing to 5.5 percent by 2019-20. The economy of São Tomé and Príncipe which is based on plantation agriculture, fishing and a small industrial sector has to import fuels,

most manufactured goods, consumer goods, and food, making it vulnerable to fluctuations in global commodity prices. Growth needs to be sustainable with some diversification of income-generating sectors. Since the scenic islands have potential for tourism, development of its tourist industry infrastructure as also of the nascent oil sector is essential for diversification to mitigate risks. With the sharp uptick in imports in 2017, the current account deficit is expected to widen from 6 percent of GDP in 2016 to 12 percent of GDP in 2017. While the CAD is expected to be financed by FDI and external project loans, in view of past declines and uncertainties in external support, what are the fallback options in case inflows do not materialize?

Volatile aid and investment inflows, even with a growing tourism sector, have kept growth moderate at around 4 percent annually, which is insufficient to alleviate poverty. The staff report mentions that the second National Poverty Reduction Strategy Paper (PRSP-II 2012-16) acknowledges little improvement in the poverty rate, which has remained over 65 percent since 2000, and weak implementation of sectoral programs in the past due to capacity constraints and limited resources. It sets ambitious objectives, including achieving a sustainable growth rate of 5.5 percent and reducing poverty to 30 percent. What would be the time-span over which poverty is to be reduced to 30 percent and what steps will be taken for this?

There exist capacity constraints in the economy at various levels. While foreign investment is welcome for bridging the current account deficit and providing a fillip to economic growth, it is essential that such investment should be sustainable. The staff report states that contracting a large amount of new debt, even on concessional terms, for very large projects could threaten debt sustainability. Does the IMF plan to provide TA to São Tome and Principe for assessing the costs and benefits of foreign investments coming into the economy to ensure sustainability?

It is encouraging that the authorities are planning to promote the business environment in the country. In the latest ease of doing business indicator, while the country has improved its ranking on several counts, there has been a marked decline in its indicator on enforcing contracts. Also, resolving insolvency needs significant improvement. As the economy plans to attract investment for promoting growth, legislating a comprehensive insolvency and bankruptcy code and operationalizing it effectively could improve the ease of doing business.

Mr. Lischinsky and Mr. Rojas Ulo submitted the following statement:

We would like to thank staff for the set of papers and Mr. Sembene, Mr. Nguema-Affane, and Mr. Carvalho da Silveira for their informative buff statement.

We support the authorities' request for the completion of the third and fourth reviews under the Extended Credit Facility Arrangement (ECF), the extension of the arrangement, and the modification of performance criteria and consequently the Proposed Decision. The program's performance was convincing and all five end-June performance criteria (PC) were met. Coherent and timely corrective measures were taken and we commend the authorities for their efforts this year to achieve improvements in growth and the fiscal, monetary and external sectors. Additionally, staff assesses that the program is broadly back on track. The authorities are strongly committed to the objectives of the ECF-supported program and are continuing to apply sound macroeconomic policies and structural and inclusive reforms.

São Tomé and Príncipe's economy shows an indication of recovery and the outlook is positive. GDP is projected to increase by 4.0 percent in 2017 and rise gradually to approximately 5.5 percent over the medium term, supported by construction, agriculture, and tourism. Overall the other key macroeconomic indicators are currently stable and exhibit a positive outlook. However, risks related to external financing and weak institutional capacity could delay the implementation of structural reforms and affect this positive perspective. We encourage the authorities to keep accelerating reform momentum submit the proposed set of laws and consolidate the improvements achieved.

Maintaining a tight fiscal policy and improving public finance remain important for consolidation in the long run. In recent years, the fiscal deficit was reduced due to hard corrective measures adopted and implemented, which in turn contained fiscal risks. However, the staff report shows that the projected recovery exposed certain vulnerabilities and, thus, if produced the possibility of creating fiscal space to generate resources and expand investment, as programmed, will be not feasible. We concur with the authorities on the need to prioritize public expenditure and reinforce domestic revenue consolidation. In this context, we support strengthening the fiscal policy framework along with the IMF's technical assistance, which will allow donors to disburse additional financing.

The financial system's soundness indicators have improved and the country has adopted policies to address financial stability. The authorities have strengthened bank supervision and upgraded the regulatory framework by adopting international practices. In the same vein, there has been a slow decrease in non-performing loans (NPLs) due to the BCSTP's NPL reduction strategy. Nevertheless, they are still high and we support staff's recommendation on the need to further reduce the level of NPLs. At the same time, monitoring and development of instruments promoting financial stability and efficiency of the financial system must continue.

We support the implementation of structural reforms to operationalize a sustainable and inclusive growth. We encourage the authorities to continue and accelerate the implementation of economic structural reforms, promoting a more diversified export strategy and inclusive growth, which will help improve the business environment, governance, and reduce poverty. In this regard, we support the National Development Plan 2017-2021 to achieve the SDGs, accelerate sustainable growth, and strengthen social cohesion. The IMF and other development partners' technical assistance, particularly learning by doing, is much needed to enhance capacity development, management, and reforms within the state administration.

With these comments, we wish São Tomé and Príncipe and its people success in their future endeavors.

Mr. Johnston and Mr. Khurelbaatar submitted the following statement:

We thank staff for the report and Mr. Sembene, Mr. Nguema-Affane, and Mr. Carvalho da Silveira for their buff statement. We are pleased that the program is back on track, after some apparent wobbles. The authorities are showing a strong commitment to program implementation and all end-June performance criteria were met. We support the completion of the Third and Fourth Reviews under the Extended Credit Facility, extension of the arrangement, and modification of performance criteria.

Fiscal consolidation, promoting development and undertaking structural reforms are a priority. We commend the fiscal consolidation and corrective measures taken by the authorities to meet the program targets, including additional revenue measures and expenditure cuts. We welcome the fact that pro-poor spending was protected. However, it is clear that economic development has not reduced extreme poverty. While the economy has been growing at a steady pace, and growth of around 4 percent is expected in the future, poverty remains stubbornly high. The authorities themselves point out

that the poverty rate has remained over 65 percent since 2000. We welcome the new National Development Plan and its ambitious targets. Can staff advise if the goal to reduce poverty to 30 percent of the population is expected to be met by 2021 or if this is a longer-term objective? Unless there is a large portion of the population only marginally on the wrong side of the poverty line, this goal may be too ambitious and affect the credibility of the plan.

The banking sector in São Tome and Principe remains highly vulnerable, with a high level of NPLs. We welcome the authorities' plan to implement International Financial Reporting Standards after the asset quality review is finished, and their resolution of Banco Equador. Greater independence and strengthening of the BCSTP will help in reducing financial sector vulnerabilities.

Mr. Ostros and Mrs. Jekabsone submitted the following statement:

We thank staff for the detailed review and Messrs. Sembene, Nguema-Affane, and Carvalho da Silveira for the informative buff statement. We welcome that the program is broadly back on track, and we encourage the authorities to remain committed to the program targets. We support the completion of the joint third and fourth reviews, the extension of the ECF arrangement to end-2018 and rephrasing of the program, in light of recently-improved program performance, and the authorities' strong commitment to keep the program on track.

We note that delays in implementing some of the structural benchmarks were due to capacity constraints thus we urge the authorities to take measures to strengthen the capacity in order to contain risks to successful performance of the program. We recognize the importance of the Fund's TA in this context.

We stress the importance of bringing the arrears clearance plan back on track and welcome the authorities' commitment to set it as a priority and prevent further accumulation of arrears. Moreover, continued fiscal consolidation is critical to stay on downward trend for public debt. We take positive note of authorities' assurance to closely monitor budget execution and match expenditures with available resources. It is critical to avoid any non-concessional financing not to threaten debt sustainability given persistent high risk of debt distress.

Finally, we echo staff in calling for continued efforts to reduce the still high level of NPLs, and vigilant supervision of the vulnerable banks, given the still vulnerable financial sector.

Mr. Saraiva and Mr. Lingoist submitted the following statement:

We would like to thank staff for the set of reports and Mr. Sembene, Mr. Nguema-Affane and Mr. Carvalho da Silveira for their informative statement. The efforts made by the São Tomé and Príncipe's authorities to bring the program back on track this year are praiseworthy. We therefore support the completion of the third and fourth reviews under the Extended Credit Facility. Noting staff considers that the capacity to repay the Fund remains strong, we also support the extension of the program to end-2018 and its rephasing.

Although risks to the ECF program remain significant, the corrective measures adopted by the government and the consequent success of the program will be important to help São Tomé and Príncipe preserve debt sustainability. In line with program goals, a closer monitoring of public spending, fiscal risks mitigation and an updated legal framework to stimulate private sector investment will be crucial to foster growth over the next few years. We consider that, along with social spending prioritization, raising growth potential will be important to reduce the country's high level of poverty. We look forward to see further efforts to meet the indicative target on the floor on pro-poor expenditures in the next reviews.

The expected economic acceleration over the next few years creates a window of opportunity to fiscal consolidation. We welcome the authorities' commitment to substantially reduce the domestic primary deficit in 2017 by cutting tax allowances and containing public spending. Maintaining further consolidation afterwards will reduce the risk of public debt distress. We agree with staff that limiting borrowing to a moderate amount of concessional loans is key to the sustainability of public debt.

We welcome the proposed regulation aiming at the development of a secondary market while we consider that it requires higher confidence among financial institutions with more transparency and adequate assessment of risks. Although the profitability of financial institutions has stabilized in 2016 after four years of negative figures, it is still limited and can be improved by reduction of NPLs levels as a result of enhanced regulation. We consider that the launch of the asset quality review (AQR) and additional actions will certainly improve credit market conditions, creating space to financial

deepening and inclusion. With regard to foreign exchange exposure, we note that the rapid decrease in loans linked to foreign exchange rate has been important to reduce external vulnerability.

Regarding the monetary policy, we note that liquidity in the financial system remains high and inflation has accelerated in 2017. Although the central bank's anchor is the exchange rate, we would appreciate staff's comments on the monetary policy rate reduction in order to stimulate economic activity and the expected impact on consumer prices.

We look forward to the implementation of the national export diversification strategy, which will assist São Tomé and Príncipe to cope with persistent deficits in current account. The diversification strategy in conjunction with enhanced business climate could stimulate higher foreign direct investment to finance the current account deficit (CAD), which is currently heavily dependent on official transfers and concessional loans. While we consider that fiscal consolidation can contain the widening of CAD, we would appreciate further comments by staff on the real effective appreciation of the dobra in 2016 and its respective impact on CAD.

At last, we look forward to the success of the strategic National Development Plan (NDP), which offers a clearer view aiming at sustainable and inclusive economic growth. With these remarks, we wish São Tomé and Príncipe and its people success in their endeavors.

Ms. Tshazibana and Mr. Tlelima submitted the following statement:

We thank staff for the comprehensive set of papers and Messrs. Sembene, Nguema-Affane, and Carvalho da Silveira for their informative buff statement.

Despite significant challenges facing São Tomé and Príncipe, the authorities have shown strong commitment to the program implementation by taking corrective measures that brought the program back on track. All performance criteria for end-June 2017 were met. We also note that the authorities have continued to make steady progress on structural reforms, notwithstanding delays due to capacity and financing constraints. We therefore support the completion of the third and fourth reviews under the ECF arrangement and the authorities' request for extension of the arrangement, and modification of performance criteria. We broadly concur with the thrust of staff's assessment and limit our comments to the following points.

Maintaining fiscal discipline is essential to meeting the program objectives, including maintaining debt sustainability. We commend the authorities for showing strong commitment by taking additional revenue and spending measures that brought the program back on track after missing the fiscal performance criteria at the end of 2016. We also welcome their determination to continue meeting the program objectives including the end-2017 fiscal target of 1.8 percent of GDP. Going forward, the fiscal consolidation path laid out in the 2018 budget is a step in the right direction, especially in light of the shortfall in budget support. Measures to limit wage growth and restrict new hiring to priority areas would be helpful in this regard. Furthermore, sustained fiscal consolidation will help maintain debt sustainability, given the conclusion of the DSA that São Tomé and Príncipe is at a high risk of debt distress. Meanwhile, while we appreciate efforts to address revenue shortfalls, we would welcome clarity about the agreement reached between the government and some private businesses and state-owned enterprises on tax arrears. We are not clear how tax-paying entities are able to withhold and then negotiate payment of their tax obligations; is this consistent with the tax law? What is the implication of Article 74 of the tax law that is referred to in the MEFP (paragraph 17)?

Tackling the fiscal risk posed by the state-owned utility company, EMAE, should be prioritized. We urge the authorities to take necessary measures to halt further accumulation of arrears by EMAE to the main oil importer, ENCO, which represents a major fiscal risk. In this regard, we welcome the ongoing efforts to revamp EMAE, with the support of the World Bank, including actions to implement least-cost production options, strengthen financial discipline, and implement full cost recovery.

Implementing structural reforms will help to promote the business environment and sustainable growth. In this context, we welcome the completion of the national Development Plan 2017-2021 that is aligned with the sustainable development goals, and is placing poverty reduction at the center of all public policies aimed at improving the welfare of the population. To this end, lessons can be drawn from the PRSP-II implementation, especially regarding prioritization of actions and ensuring availability of adequate resources, in terms of both human capacity and financial resources.

Ms. McKiernan and Mr. Sylvester submitted the following statement:

We thank staff for their insightful report and Messrs. Sembene, Nguema-Affane, and Carvalho da Silveira for their informative buff

statement. We commend the São Toméan authorities for their strong effort in bringing the Extended Credit Facility (ECF) arrangement back on track. Following policy slippages in 2016, the authorities have restored credibility to program implementation by meeting all Performance Criteria (PCs) for end-June 2017 and by making significant progress on their structural reform agenda. In this regard, we support the completion of the third and fourth reviews under the ECF arrangement, the extension of the arrangement, and the modification of PCs. As we broadly support the thrust of staff's report, we offer the following remarks for emphasis.

Continued strong commitment is needed to avoid further setbacks to program implementation. The ECF suffered several setbacks during 2016, including missed PCs and delays in implementation of important structural reforms. These setbacks also affected the flow of donor support. However, in 2017, the authorities took strong remedial measures to return the program to a sound footing. That said, strong resolve is needed going forward to avoid further slippages and to safeguard the program's credibility and success. In this regard, could staff comment on how the current policy environment will avoid a repeat of the 2016 challenges, especially ahead of the July 2018 legislative elections?

Additional fiscal consolidation is needed to achieve end-2017 program targets and address medium-term debt sustainability concerns. In light of anticipated revenue shortfalls this year, the authorities have identified additional measures to close the gap. Low domestic fiscal revenues are also a concern and merit strong actions. We welcome the assertion that the authorities also stand ready to take further measures as necessary to ensure that expenditure commitments remain within available resources. Going forward, the authorities have also committed to further fiscal consolidation and debt management reforms, including limiting external borrowing to only concessional loans and adhering to an indicative annual limit of 4 percent of GDP to mitigate the country's high risk of debt distress. In this regard, the authorities have submitted to the parliament the 2018 budget, which is consistent with the parameters of the program. We view this as an important first step. However, a more critical step is budget implementation. Accordingly, close monitoring and surveillance are critical to gauge steady progress in line with targets. Could staff comment on what mechanisms are in place as early warning signals to spot deviations from program targets and trigger corrective actions, especially in light of past experiences?

We note with concern that program implementation has been affected by capacity constraints and delays in technical assistance from the Fund and

other partners. While we appreciate that there is a high demand for Fund's TA, we believe that every effort should be made to support the authorities in undertaking much-needed reforms. Going forward, every effort should be made to avoid further delays in delivering TA.

The financial sector has seen some strengthening but remains vulnerable. We note positively that the central bank is pressing ahead with financial sector reforms, stepping-up supervision, and making good progress in implementing the NPL reduction strategy. However, high NPLs continue to be a major constraint to reviving credit growth. We encourage the authorities to press ahead with their efforts to reduce the still-high level of NPLs as well as ensure vigilant supervision of vulnerable banks.

The near- and medium-term outlook for economic growth is favorable despite risks. Economic growth is expected to remain strong at around 4 percent in 2017 and to reach 5 ½ percent over the medium term driven by tourism, agriculture, and externally-funded investments. We understand from staff that the risks are balanced and manageable. We note, however, that poverty remains extremely high despite relatively strong growth over the years. In this regard, we welcome the ongoing efforts to promote the business environment and economic growth, as elaborated by staff and highlighted in the buff statement, including the elaboration of the export diversification strategy and the private sector strategy, which should strengthen growth prospects and place São Tomé and Príncipe on a higher, sustainable, and more inclusive growth path.

Mr. Inderbinen and Ms. Andresen submitted the following statement:

We support the completion of the third and fourth reviews under the Extended Credit Facility, as well as the request for extension of the arrangement and modification of performance criteria. After an insufficient program performance at the December 2016 test date, we welcome the authorities' corrective measures. These have ensured that the June 2017 targets were met and the program is now broadly back on track. We also take good note of the authorities' continued commitment to the program, as outlined in the buff statement by Messrs. Sembene, Nguema-Affane, and Carvalho da Silveira.

Given the high risk of debt distress, reaching the fiscal targets is of utmost importance. We welcome the authorities' determination in this regard, as underlined in the buff statement. Continued progress in addressing the large losses of EMAE is key to tackle fiscal risks. Further, to ensure that debt is

sustainable over the longer term, it is crucial that the authorities eschew non-concessional borrowing and strictly limit the contraction of commercial loans, as outlined in the authorities' borrowing plan. Finally, in view of recent history, any fiscal slippage in context of the July 2018 elections should be avoided.

Containing public spending is key to create space for growth enhancing structural reforms and pro-poor spending, in line with the authorities' development goals. The considerable delays in the completion of a PIMA, the law on a new VAT, and the law on PPPs are regrettable. Given the authorities' important capacity constraints in the implementation of structural benchmarks, adequate provision of technical assistance, with a focus on its effectiveness, by the Fund and the World Bank will be crucial going forward. In light of the continued structural challenges, we support the extension of the arrangement to facilitate the implementation of reform efforts that are already underway.

Ms. Villa and Ms. Ong submitted the following statement:

We thank staff for a comprehensive report, and Messrs. Sembene, Nguema-Affane and Carvalho da Silveira for their helpful buff.

The economic performance of São Tomé and Príncipe remains robust and the near-to-medium term outlook appears positive. We are heartened that the ECF program continues to support the authorities in safeguarding macroeconomic stability, advancing reforms and catalyzing financing amidst a challenging environment, as set out in the buff. We note that following fiscal slippages in 2016, strong corrective actions have brought program implementation back on track, with all end-June 2017 performance criteria (PC) met. We support the completion of the third and fourth reviews under the ECF, extension of the arrangement, and proposed modifications to the performance criteria. We broadly concur with the thrust of the staff appraisal and offer the following comments for emphasis.

Continued fiscal discipline is necessary, albeit challenging in the context of São Tomé and Príncipe's investment needs. Given that the country remains at high risk of debt distress, sustained fiscal prudence will be needed to shift debt onto a downward trajectory. In this regard, we welcome the authorities' strong commitment to fiscal consolidation and containing fiscal risks, including the remedial actions taken to address end-2016 fiscal slippages and reform EMAE, as well as the measures they have identified to safeguard end-2017 fiscal targets. Could staff provide more information on

the capital expenditures that have been deferred as part of the latter effort (paragraph 14)? Further, given that revenue underperformance has not been uncommon in São Tomé in recent years, could staff comment on implementation risks to the authorities' plans for closing the 2017 revenue gap, including relating to the expected receipt of import duties from ENCO? We also commend the authorities for protecting social spending even as they have made difficult expenditure cuts.

Decisive efforts will be needed to strengthen financial stability. NPL ratios in the banking sector remain very high. In this regard, we are encouraged that the authorities have continued to implement their NPL reduction strategy, that past-due loans have been declining gradually, and that a World Bank-supported asset quality review is commencing. But we note that domestic infrastructure for NPL resolution appears to be limited. Could staff comment on the expected timeline for the establishment of an out-of-court settlement mechanism, and whether there has been any discussion of other options to expedite NPL resolution, such as through the participation of an asset management company? We also note that the authorities are in the process of redenominating the currency, and while appreciate that measures are being taken to raise awareness and promote a smooth transition, we invite staff comments on whether there might be any inadvertent impact of the redenomination on economic activity?

We strongly support continued technical assistance (TA) to assist São Tomé and Príncipe in undertaking structural reforms. It is heartening that the authorities have found TA from the Fund and other development partners to be useful. We fully agree with staff that continued capacity development is essential to help the authorities learn-by-doing, and to gradually build much needed domestic capacity. In the context of program performance, we note that delays in TA delivery have affected the implementation of structural benchmarks. We think that this is notable and of broader concern in the context of risks to surveillance and capacity development highlighted in the 2017 Risk Report. We underscore the importance of Fund TA to support the development of small and fragile states as well as low-income countries, and in this regard strongly support the continued delivery of TA to the São Toméan authorities.

With these remarks, we wish the authorities the very best in their endeavors.

Mr. Alogeel and Mr. Rawah submitted the following statement:

We thank staff for the helpful report and Mr. Sembene, Mr. Nguema-Affane, and Mr. Carvalho da Silveira for their informative buff statement. In view of the satisfactory program performance, the adoption of corrective measures, and the authorities' commitment to the program's objectives despite important challenges, we support the proposed decision. Here, will limit our comments to the following points for emphasis.

We take positive note of the favorable near- and medium-term economic outlook. At the same time, we encourage the authorities to continue their efforts to address the current challenges, including the fiscal risks. We welcome the implementation of the National Development Plan (NDP), as noted in the buff statement, as it is an important step toward promoting sustainable growth and strengthening the social cohesion. We also look forward to the completion of the national export diversification strategy by mid-2018.

On the fiscal front, we are encouraged by the authorities' efforts and plans, including strengthening public financial management, bolstering revenue mobilization, and clearing the stock of arrears. At the same time, given the high risk of debt distress, we echo staff's view on the need to continue fiscal consolidation, limit non-concessional loans, diversify the economy, and expand the export base to safeguard macroeconomic and fiscal sustainability.

Finally, we take positive note of the authorities' efforts regarding the development of a secondary market and the preparation to introduce long-term instruments, which are useful for managing liquidity. In addition, we commend the authorities for the steps taken to deal with the high NPLs, notably through the launch of the Asset Quality Review (AQR) with the support of the World Bank. We encourage the authorities to continue their close supervision of vulnerable banks.

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

Mr. de Villeroché, Mr. Castets and Mr. Bellocq submitted the following statement:

We thank staff for their comprehensive set of reports and Mr. Sembene, Mr. Nguema-Affane and Mr. Carvalho for the insightful buff statement.

After a significant fiscal slippage last year, the program implementation has been back on track thanks to the correctives measures taken by the authorities. The end-June 2017 performance criteria were met and staff notes that structural reforms are progressing although at a slower pace than anticipated. Against this background, we support the completion of the third and fourth reviews under the ECF arrangement, as proposed by staff. Following staff's recommendations, we also support the authorities' request for waivers for nonobservance of the end-December 2016 PCs on Domestic Primary Balance (DPD) and changes in net bank financing of the central government.

Economic Growth

Economic growth has been revised downward and inflation has risen faster than expected under the second review. We note positively that potential future growth acceleration could result from robust activity in construction, agriculture, and tourism in the medium term and that sizable infrastructure projects are expected in the transportation and energy sectors. Notwithstanding this positive outlook, we urge the authorities to make economic growth much more inclusive as the poverty rate has remained over 65 percent since 2000 according to the staff's report. Could the staff further explain how the IMF-supported program will help in alleviating poverty?

Fiscal Policy and Debt Dynamics

On the fiscal side, we expressed some doubts in our Gray on the second review about the feasibility to lower the DPD to 2 percent of GDP in 2016. As noted by staff, the DPD reached 4 percent of GDP last year, leading the authorities to take corrective measures to bring back the fiscal policy on a more sustainable track. For 2017 nevertheless, achieving the fiscal target could remain difficult as revenue might have been lower than expected as noted by staff. Indeed, we note that DPD target is at 1.8 percent of GDP for the whole year whereas the DPD reached 2.7 percent GDP in August on an annualized basis. These unsatisfactory outcomes result from the fact that the program had insufficient impacts in terms of Domestic Resources Mobilization so far. Tax revenue is expected at 13.4 percent of GDP in 2018,

a level to compare to 14.3 percent of GDP reached in 2015. Against this background, could staff provide its assessment of the efficiency of IMF Technical Assistance on tax administration issues and Public Finance Management?

As the updated Debt Sustainability Assessment shows that public debt remains at a high risk of distress, we urge the authorities to make their best efforts to bring down the public debt to a more sustainable level and to take the opportunity of the IMF-supported program to mobilize further concessional borrowing.

Banking System and Asset Quality Issues

We encourage the authorities to remain committed to the Non-Performing Loan reduction strategy. A sound and deep banking system is key to support growth, diversification and social inclusion. We note support staff's proposal to postpone the completion date of the Asset Quality Review (Structural benchmark) from end-December 2017 to end-June 2018. We expect that this review will pave the way to a strengthened banking system associated with improved lending and provisioning practices.

Mr. Sabharwal and Mr. Vitvitsky submitted the following statement:

We thank staff for the reports and Messrs. Sembene, Nguema-Affane, and Carvalho da Silveira for a helpful buff statement. We support the completion of the third and fourth reviews under the Extended Credit Facility (ECF), the extension of the program, and the requested modification of performance criteria.

We welcome the São Tomean authorities' corrective actions to address fiscal slippages and achieve the end-June 2017 performance criteria. We also welcome the authorities' commitment to achieve the end-2017 domestic primary deficit (DPD) target of 1.8 percent of GDP. However, the DPD was already 2.7 percent of GDP in August (annualized), much higher than the target. Since São Tome and Principe remains at a high risk of debt distress, the government must solidify the improvements in fiscal policy, as its long-term outlook is not sustainable if fiscal performance reflects past trends. We also strongly support the zero limit on new non-concessional borrowing and are pleased to see that authorities have consistently met this PC under the program.

Separately, staff project real GDP growth to average 5.5 percent over the medium-term, even though it has exceeded 5 percent only 4 times over the last 20 years and averaged 4.3 percent over the last decade. SPR has told the Board that economic growth forecasts used in DSAs for LICs have tended to be overly-optimistic, while the Risk Management Unit has also identified overly-optimistic forecasting, particularly in program countries, as a key risk. As a result, we would be interested in the confidence intervals around the 5.5 percent average growth forecast for São Tome and Principe.

Along these lines, we hope that the Fund and other multilateral institutions can provide requisite technical assistance (TA) on structural fiscal reforms. The staff notes in paragraph 18 that there have been both capacity constraints and delays in Fund TA. This underscores the importance of realistic targets and structural reform benchmarks that take into account São Tomean capacity and donor support. Can staff please elaborate on the specific constraints and reasons for the delays in Fund TA provision? Can staff also comment on the efficacy of government expenditures and whether there are any diagnostics or TA planned to support the efficient use of donor resources?

Mr. Saito and Ms. Mori submitted the following statement:

We thank staff for the informative paper and Mr. Sembene, Mr. Nguema-Affane, and Mr. Carvalho da Silveira for their helpful statement. São Tomé and Príncipe's macroeconomic conditions and outlook are favorable: GDP growth is projected to pick up to 5.5 percent over the medium term; inflation should gradually wind down to around 5 percent; and fiscal consolidation is expected to narrow the domestic primary deficit to 1 percent of GDP in the medium term. However, significant risks, such as delays in structural reforms, shortfalls in external financing and July 2018 legislative elections, remain and continuous efforts are needed. Given that the authorities adopted corrective measures to bring the program back on track after missing the end-2016 fiscal targets by large margins and have shown commitment to keep the program on track going forward, we support the completion of the joint third and fourth reviews and the request for waivers for nonobservance of the end-December 2016 performance criteria (PCs) and extension of the ECF arrangement. As we agree with the thrust of the staff's appraisal, we will limit our comments to the following points:

Fiscal and Debt Policy

We welcome that the authorities took corrective measures such as a prudent expenditure execution and tax measures to bring the program back on

track. We also positively note that the authorities submitted a 2018 budget in line with the program, and show their commitment to continue fiscal consolidation in 2018 while safeguarding social spending. To further enhance domestic revenue mobilization, we encourage the authorities to prepare for the introduction of VAT with support from the Fund TA.

Although the external debt to GDP ratio is expected to continue to decline moderately in the coming years, São Tomé and Príncipe is already in external arrears with some bilateral creditors and remains at a high risk of debt distress, according to the DSA. As shown in the DSA baseline scenario, it is important to continue fiscal consolidation, eschewing non-concessional loans, and working to diversify the economy and expand the export base to maintain debt sustainability over the medium term. We also note that a large amount of loans, even at concessional terms, would threaten debt sustainability. In this context, it is encouraging that the authorities have committed to limit external borrowing to only concessional loans, with an indicative annual ceiling of 4 percent of GDP. We welcome that domestic arrears were audited and recognized by the government and added to DSA for the first time.

Considering that the continued large arrears accumulation by EMAE to ENCO represents a major fiscal risk, reforms of State-owned enterprises are crucial. In this regard, we encourage the authorities to implement the adopted reform plan for EMAE, consistent with full cost recovery, and continue to take steps to limit losses at EMAE in the near term.

Financial Sector

It is encouraging that the Banco Central de São Tomé e Príncipe (BCSTP) has stepped-up supervision, conducted internal asset quality assessments, and made progress in implementing the NPL reduction strategy. It is also a welcome step that the BCSTP required all banks to publish their 2016 financial statements to increase transparency and promote interbank activity. However, we concur with the staff that continued efforts are needed to reduce the still-high level of NPLs, and vigilant supervision of vulnerable banks should be maintained.

Program Issues

We welcome that the all five end-June 2017 PCs are met. We note that the implementation of structural reforms under the program is progressing with delay. As failure to implement structural reforms could hinder investment and growth, we encourage the authorities to implement the

reforms, including strengthening revenue mobilization, improving PFM, and taking initial steps to contain the fiscal risk of EMAE, with TA supports from the Fund and other institutions while effectively using extended program term.

Mr. Daïri and Mr. Abradu-Otoo submitted the following statement:

We thank staff for the report and Messrs. Sembene, Nguema-Affane, and Carvalho da Silveira for their helpful buff statement.

São Tomé and Príncipe continues to face a variety of challenges and risks stemming from infrastructure constraints, inadequate capacity, shortfalls in external financing, and a high risk of debt distress. Despite adverse external developments, the economy is expected to grow at 4 percent in 2017 and 5 ½ percent thereafter with a moderate uptick in inflation. Program implementation for the third and fourth review under the ECF arrangement has been satisfactory, and corrective measures have been taken to address end-2016 lapses and put the program back on track. We note that the mixed implementation of structural reforms under the program is due mainly to capacity constraints and delays in the delivery of technical assistance. Could staff comment on the reasons behind these delays, and what steps have been taken to ensure timely delivery of TA in support of program objectives? We agree with the thrust of the staff appraisal and, in view of the authorities' continued commitment to program implementation, we support the proposed decision.

We welcome the corrective revenue and expenditure measures that have been introduced following the 2016 slippages, and those included in the revised 2017 budget. These are expected to reduce the domestic primary deficit (DPD) to 1.8 percent of GDP in 2017 and 1 percent of GDP in the medium-term. We stress the importance for the authorities to stay on course with fiscal consolidation to further reduce public debt and support the pegged exchange arrangement. We take a positive note of the efforts to roll out the VAT regime, which is progressing steadily, and encourage steadfast implementation of the tax administration reform measures outlined in the supplementary MEFP (paragraphs 20, 21). Structural fiscal reforms will be key in ensuring lasting improvement in the fiscal situation, including building capacity for managing public investment, bringing the arrears clearance plan back on track, and reducing fiscal risk posed by the state-owned utility company through improved operational efficiency and financial sustainability with assistance from the World Bank and the European Investment Bank.

Notwithstanding the bad debt risk rating in the DSA, with ongoing fiscal consolidation and prudence in contracting new debt and tackling domestic arrears, staff assessment points to improvement in debt indicators over the medium term. As highlighted in the buff statement, the authorities are actively working towards reaching rescheduling agreements of external arrears, and we call for steadfast progress in this area. In the DSA report, the authorities suggest that under a customized scenario with large infrastructure projects, growth outcomes could be higher, leading to higher debt-carrying capacity and in this regard, they highlight the need to allow for adjustment of the indicative limit for concessional borrowing to finance critical growth-enhancing infrastructure projects. The staff may wish to comment.

We take note of the improvements in financial soundness indicators, with capital adequacy ratios well above regulatory requirements and rising profitability. Nonetheless, vulnerabilities and challenges remain with high—albeit marginally declining—NPLs, excess liquidity, and low credit growth. We take note of the progress in the liquidation of Banco Ecuador, and are encouraged by the advances made in strengthening supervision and implementing the NPL reduction strategy, including the launch of the AQR with World Bank assistance. Going forward, the authorities should continue with efforts towards financial sector reform, as detailed in the MEFP, and step up supervision of vulnerable banks. The recently implemented Financial Sector Development Implementation Plan, the BCSTP Strategic Plan, and the envisaged implementation of the International Financial Reporting Standards and revamping of risk-based supervision with Fund TA are all steps in the right direction.

We welcome the completion of preparation of the National Development Plan 2017-21, which focuses on accelerated reforms to achieve high sustainable growth and poverty reduction by promoting export diversification, tourism, and improving the supply of electricity and reducing its cost. Improving the business environment to enhance private sector participation in the economy will be of essence, and we encourage the authorities to redouble efforts in this area. A key risk in all these areas is the country's weak capacity, which needs to be addressed to avoid delaying implementation of important reforms and sectoral development programs. Given São Tomé and Príncipe's fragile state situation and its growth potential, we call for accelerated delivery of capacity building from all sources, including the Fund.

Mr. Jin and Mr. Fan submitted the following statement:

We thank staff for the comprehensive papers and Messrs. Sembene, Nguema-Affane and Carvalho da Silveira for their informative buff statement. We welcome the favorable macroeconomic conditions and outlook, and take positive note of the authorities' strong commitment to bring the program broadly back on track. Given the improved program performance, we support the completion of the third and fourth review, the proposed modification of performance criteria, and the extension of the arrangement.

Fiscal consolidation is critical to contain debt risk and maintain sustainable economic growth. We congratulate authorities' success in meeting their fiscal target again after a slippage in 2016, and welcome the authorities' measures to save fiscal budget and the fiscal structural reforms including the automatic price adjustment mechanism. Although the large-scale infrastructural renewal is critical to develop tourism, it is essential to keep debt in a sustainable path. we support the staff's recommendations to limit borrowing to a moderate amount of concessional loans and keep sound fiscal discipline, and suggest to match the pace of construction with the current capability and external concessional resources. We noticed that the effect of the PIT formula correction is negative, and the newly introduced consumption tax and alcoholic beverages duty did very little to increase fiscal revenue. We welcome staff's further elaboration on the reason for the weak tax performance, and how to diversify the financing channel for infrastructural construction.

We welcome the ambitious National Development Plan (NDP) from 2017 to 2021, as well as the private sector strategy and national export diversification strategy. However, it is necessary to design more measures and a specific timetable to translate these strategic blueprints into feasible practices.

Since the NPL level remains high, we encourage the authorities to enrich toolkits and strengthen the legal basis on NPL resolution. Also, we noticed that the central bank plans to redenominate its currency in January 1st, 2018. We welcome this initiative, but would call for close monitoring to avoid potential financial risks.

Mr. Hurtado and Mrs. Suazo submitted the following statement:

We thank staff for its useful report and Messrs. Sembene, Nguema-Affane, and Carvalho da Silveira for their comprehensive buff

statement. We support the completion of the third and fourth reviews under the Extended Credit Facility, as well as the modifications to the arrangement. We commend the authorities for their successful efforts in bringing the program broadly back on track after slippages in 2016.

We generally concur with staff's assessment and would just like to comment on the following issues:

Due to the continued high risk of debt distress, we encourage authorities to continue their tasks in pursuing fiscal consolidation, prioritizing structural fiscal reforms, such as setting a single Tax Authority and revamping EMAE (by implementing least cost-production options and moving to full cost recovery), as well as bringing the arrears clearance plan back on track. In this regard, could staff provide further detail on the difficulties that the São Tomean economy has faced in implementing the VAT, which has been postponed several times despite their shortages in much needed fiscal revenue.

To reach the program targets for end-2017, additional measures, such as cuts in capital expenditures, are envisaged. Could staff expand on the growth impact this will have on the provided estimates for economic activity as well as the risks of not being able to reach the targets, specifically in expenditures? Additionally, despite a favorable economic outlook, slow credit growth remains. Could staff elaborate on the reasons behind this performance?

The authorities have made improvements in strengthening financial soundness but the banking sector remains vulnerable. Could staff explain what led to the liquidation of Banco de Ecuador and what effect did it have on the banking system and if systemic risks remain.

The staff reports that due to capacity constraints and delays in technical assistance, programmed fiscal reforms are proceeding slowly. Could staff comment if TAs are planned in the short run for São Tomé and Príncipe to assist in overcoming future setbacks and to secure results?

With these, we wish São Tomé and Príncipe's authorities success in their future endeavors.

Mr. Bayar made the following statement:

We thank staff for the comprehensive report and Mr. Sembene, Mr. Nguema-Affane, and Mr. Carvalho da Silveira for their helpful buff statement.

Since we did not issue a gray statement, I would like to make a few points. First, against a challenging backdrop, we appreciate that the authorities have managed to put in place a rigorous set of corrective measures that allowed them to progress reasonably well on their structural reform agenda. In view of the continued program ownership by the São Tomean authorities and the staff's positive assessments of the program conditionality, we would like to support the completion of the third and fourth reviews under the Extended Credit Facility (ECF), the extension of the arrangement, and proposed modifications to the performance criteria.

Second, on the fiscal policy, we positively note the authorities' successful adoption of corrective measures and the eventual meeting of all June 2017 performance criteria, which keeps the end-year target growth within reach. We also encourage the São Tomean authorities to address the contingent liabilities and arrears, particularly through the steps to be taken in the state-owned enterprise (SOE) sector. To this end, the Fund's continued and timely technical assistance (TA) engagement is essential.

Third, like Mr. Gokarn, we are concerned with the rapid rise in the current account deficit from 6 percent of GDP in 2016, to 12 percent level this year, despite the program anchor in place. We, therefore, call for continued vigilance on the external balances, as a worsening of the currently benign external environment could jeopardize the traction of the program targets.

Finally, on the financial sector, while we appreciate the recent steps taken by the authorities, we continue to see further improvements in this area as a prerequisite for success of the São Tomean economic program. In particular, given the high level of nonperforming loans in the banking sector, we call on the authorities to persevere with the NPL reduction strategy and to expedite residual remedial steps as envisaged. Taking this opportunity, we would like to wish the São Tomean authorities success in their endeavors.

Mr. Saito made the following statement:

We thank the staff for the comprehensive reports and Mr. Sembene and others for their informative statements. We issued a gray statement and

support completion of this review. We would like to limit ourselves to two comments for emphasis, regarding debt sustainability and TA.

First, we urge the authorities to make every effort to restore debt sustainability. The staff assessed that São Tome and Principe remains at high-risk of debt distress and has external arrears. We welcome the authorities' commitment to avoid accumulation of new arrears this year and to limit external borrowing to only concessional loans, which are near the ceiling of 4 percent of GDP.

Meanwhile, we note that the authorities indicate the need to allow for adjustment of the ceiling for key projects that could unlock growth potential. However, as mentioned in the Debt Sustainability Analysis (DSA) paper, large amount of loans, even at concessional terms, would threaten debt sustainability.

Against this backdrop, we support the staff's answer to technical questions and encourage the authorities to remain cautious when considering external borrowing, carefully taking into account the project's costs and benefits, urgency, and impact on GDP growth and debt-carrying capacity.

Second, we stress that continuous TA by the Fund and other institutions is crucial for implementation of structural reforms by the authorities. In this regard, we note that there have been delays in the delivery of some TA due to the capacity constraints on both the Fund's and the authorities' sides. In this context, closer communications among country teams and key departments and authorities is required to ensure that necessary TA is provided without delay.

The staff representative from the African Department (Ms. Li), in response to questions and comments from Executive Directors, made the following statement:¹

I thank Directors for the gray statements and the questions posted. The staff circulated written responses to the technical questions; and now I would like to provide a few more comments.

First, I would like to update that the authorities have met the prior actions. They adopted a 2018 budget, which is consistent with the program, and submitted it to the parliament for approval. This new budget aims at 1 percent of GDP domestic primary deficit, consistent with the program, and

¹ Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

also incorporated conservative revenue projections and contained wage growth. With that, we assess that they have met the prior actions.

There were a number of questions about the feasibility of 2017 targets and 2018 targets, especially in light of developments last year and the upcoming legislative elections. In the staff's view, these targets are feasible for the following reasons.

First, the revenues have been projected very conservatively for both 2017 and 2018. They have incorporated the negative revenue development in 2016, and the conservative projections would help to make sure that there will be no over-commitment on the expenditure side.

To provide an example of the conservative revenue projections, the authorities have started to collect tax arrears, but we only incorporate the revenue yields from the contract that has been signed—also there are a few installments that have been paid—as evidence that the potential estimate is feasible.

On the expenditure side, since this year, the authorities have been able to keep spending in check as they wait for revenue to be realized before they commit, and they have been doing this for the first three quarters. That is why they met the end-June target. For the September indicative targets, we recently received information that the authorities met the indicative target for the domestic primary balance.

The authorities have shown their commitment, and they should be able to do that for the rest of the year. In addition, for 2017, one of the major measures is to collect tax arrears from ENCO, one of the large oil suppliers; and that measures amount to about 0.8 percent of GDP. In November, they have already reached an agreement and collected that revenue, so that would help to ensure the achievement of 2017 target. With this, we believe the 2018 target is also realistic because the revenue estimates are conservative and the authorities are committed to holding expenditures in line with revenue.

There were also a few comments and questions about Fund TA and the structural benchmarks. São Tomé and Príncipe is a fragile state with limited institutional capacity. That is why in these countries, capacity development has an important role to play for advancing reform agendas. Indeed, the Fund has already provided a significant amount of TA. If one looks at the information appendix, one will see that a significant amount of TA has been provided. However, there are cases where some TA was delayed. Part of that

is because a huge demand for Fund's TA. There is excess demand. In this case, some of the TA was delayed.

However, at the same time, the Fund's externally financed capacity development program is helping to provide TA. One prominent example is the Revenue Mobilization Trust Fund, which is financing peripatetic advisors to help the authorities to implement a VAT. This is hands-on support, including on how to find the space and how to hire personnel to run the unit. I am happy to report that the authorities are on track to meet the rephased target for end-June 2018 to adopt the VAT law.

In addition, the authorities recently joined Central Africa Regional Technical Assistance Center, which is also externally financed. By joining the center, they should be able to receive on-the-ground and hands-on support, which should help them further strengthen their implementation capacity.

There were a few questions on the financial sector and monetary policies. Regarding the benchmark lending rate, the authorities lowered the lending rate in June when inflation was trending down. Because this lending rate has limited transmission to the monetary aggregates and have limited impact on inflation, we assess that lowering the rate did not really affect the inflation process. Indeed, recent inflation was mostly caused by the production of vegetables and fish, which was interrupted by excessive rain during the spring. We expect the factors are mostly transitory and not related to the interest rate change.

There was also another question about establishing the arbitration center for the out-of-court settlement of non-performing loans. This has been progressing well. The authorities have identified the judges with the requisite skills and provided the training. At the same time, the regulations for the center have been approved. We are hopeful that the center will be up and running by the end of 2018.

Lastly, there were also questions about the liquidation of Banco Equador. That bank was put under liquidation after no potential buyer was assessed to be meeting the fit and proper test. So far, there has not been a direct impact in the banking system because the linkages between banks are weak. The fiscal cost has been quite limited, less than one quarter percentage point of GDP, mostly in the form of paying small, non-connected lenders.

Mr. Razafindramanana made the following concluding statement:

We thank Directors for supporting the conclusion of the third and fourth reviews under São Tome's ECF arrangement. We are also thankful to the mission chief, Ms. Li, and her team for the valuable advice and the constructive engagement they have maintained with the authorities during policy discussions. Since the staff has provided answers to the questions raised by Directors, I will limit myself to a few remarks.

First, we welcome Directors' acknowledgement of the decisive, difficult corrective measures that the authorities have successfully taken following the weaker-than-expected fiscal performance in 2016. In this regard, steps taken to reform SOEs and advance the introduction of the VAT have been critical in signaling the authorities' continued commitment to program objectives and restoring satisfactory performance under the ECF arrangements.

The São Tome and Principe authorities share Directors' views on the importance of pursuing efforts to ensure debt sustainability over the medium term and prevent further accumulation of arrears. To this end, my authorities are committed to pursuing prudent public debt management with a view to improving debt indicators and debt distress ratings over time. We are also determined to stay on course with fiscal consolidation, including through policies aimed at containing expenditures and boosting domestic revenue mobilization. In this respect, my authorities look forward to Fund TA in support of the planned establishment of a single tax authority in the country. More generally, Fund TA will be critical to strengthen institutional capacities, thus facilitating achievement of fiscal objectives under the program.

Second, the authorities will pursue their reform efforts to address vulnerabilities in the banking system in line with Directors' views. In this regard, strengthening the supervisory framework and reducing the level of non-performing loans rank high on the authorities' agenda.

Going forward, major in-roads will continue to be made in implementing the central bank strategic plan, the NPL reduction strategy, and the Financial Sector Development Implementation Plan. In addition, my authorities are also working to ensure that the central bank and commercial banks can become fully IFRS compliant following the completion of the asset quality review.

The process of liquidating Banco Ecuador will also continue. An action plan has already been prepared and submitted for approval to the courts. My authorities will continue to monitor the implementation of a plan as soon as it is approved.

Finally, my authorities agree with Directors on the need to accelerate structural reforms, notably those aimed at fostering growth, promoting economic diversification, improving the business climate, and strengthening the performance of the electricity sector. With the support of the World Bank and the African Development Bank, my authorities are working on the implementation of a private-sector development strategy and international export diversification, centered on promoting sustainable tourism.

However, in addition to the authorities' strong commitment to their structural reform agenda, capacity building from the Fund and other multilateral institutions will play a critical role in facilitating sound policy formulation and timely reform implementation in a small and fragile state such as São Tome and Principe.

To conclude, we reiterate my authorities' commitment to advance the policy and reform agenda set forth in the ECF. In this endeavor, they look forward to continued and timely provision of Fund's assistance in support of their reform program.

The following summing up was issued:

Executive Directors commended the São Tomé and Príncipe authorities for taking decisive action to bring the program back on track following slippages in 2016. They supported the completion of the reviews under the ECF arrangement, the request for modification of program targets and extension of the arrangement. Going forward, Directors encouraged the authorities to remain steadfast with program implementation to ensure macroeconomic stability and promote sustainable, inclusive growth while taking steps to alleviate poverty. They took note of implementation risks from the forthcoming legislative elections.

Directors welcomed the fiscal measures taken by the authorities to meet the end-December 2017 domestic primary deficit target and their commitment to keep expenditure in line with available resources to achieve this goal. They also welcomed steps taken to address fiscal risks posed by the large operational losses of the state-owned electricity and water enterprise. Public financial management reforms are required to prevent the accumulation

of new domestic arrears. Directors underlined the need for continued progress on fiscal reforms, including the adoption of a VAT, and for reducing the stock of arrears.

Directors noted that the 2018 budget submitted to parliament was in line with program objectives and would advance fiscal consolidation. Directors recommended that the contracting of new concessional debt be kept to a measured pace and encouraged the authorities to reach agreement with creditors on external arrears.

Directors welcomed the improvement of financial soundness indicators and progress made in strengthening banking supervision. However, the high level of non-performing loans should be addressed and further steps are required to safeguard financial stability.

Directors welcomed the 2017-21 National Development Plan and commended efforts to diversify the economy and improve the business environment to raise growth.

The Executive Board took the following decision:

Democratic Republic of São Tomé and Príncipe—Third and Fourth Reviews Under the Extended Credit Facility Arrangement, Extension of the Arrangement, and Modification of Performance Criteria

1. The Democratic Republic of São Tomé and Príncipe has consulted with the Fund in accordance with paragraphs 4.A(b) and 4.B(b) of the arrangement for the Democratic Republic of São Tomé and Príncipe (EBS/15/71, 06/26/2015 the “ECF Arrangement”) in order to review program implementation.

2. The letter dated November 16, 2017 from the Minister of Finance, Commerce and the Blue Economy and the Governor of the Central Bank of São Tomé and Príncipe (the “November 2017 Letter”) together with its attached Memorandum of Economic and Financial Policies (the “November 2017 MEFP”) and Technical Memorandum of Understanding (the “November 2017 TMU”) shall be attached to the Arrangement and the letter dated June 19, 2015 from the Minister of Finance and Public Administration and the Governor of the Central Bank of São Tomé and Príncipe, together with its attachments, as supplemented and modified, shall be read as further supplemented and modified by the November 2017 Letter and its attachments.

3. Accordingly, the ECF Arrangement for the Democratic Republic of São Tomé and Príncipe shall be amended as follows:

a. In the introductory paragraph, the words “three-year arrangement” shall be replaced with “arrangement” and the words “three-year period of the arrangement” shall be replaced with “period of the arrangement”.

b. Paragraph 1(a) of the ECF shall be amended by replacing the reference to “For a period of three years from the date of the approval of this arrangement” with “For a period from July 13, 2015 to December 31, 2018”.

c. A new paragraph 2(g) of the ECF Arrangement shall be added as follows:

“2(g) the seventh disbursement, in an amount equivalent to SDR 634,290, will be available on or after October 15, 2018, at the request of the Democratic Republic of São Tomé and Príncipe and subject to paragraphs 4 and 5 below.

d. In paragraph 4.B(a) of the ECF Arrangement, with respect to the sixth disbursement, the reference to “Table 3 of the November 2016 MEFP and further specified in the November 2016 TMU” shall be replaced with “Table 3 of the November 2017 MEFP and further specified in the November 2017 TMU”.

e. In paragraph 4B(b) with respect to the sixth disbursement the reference to “paragraph 19 of the November 2016 MEFP shall be replaced with “paragraph 36 of the November 2017 MEFP”.

f. A new paragraph 4(C) of the ECF Arrangement shall be added to read as follows:

“4.C the Democratic Republic of São Tomé and Príncipe will not request: The seventh disbursement under this arrangement specified in paragraph 2(g) above:

(a) If the Managing Director of the Trustee finds that, with respect to the seventh disbursement, the data as of June 30, 2018 indicate that:

- (i) the floor on domestic primary balance, or
- (ii) the ceiling on changes in net bank financing of the central government, or
- (iii) the floor on net international reserves of the central bank,

as set out in Table 3 of the November 2017 MEFP and further specified in the November 2017 TMU was not observed; or

(b) until the Trustee has determined that, with respect to the seventh disbursement, the sixth program review referred to in paragraph 36 of the November 2017 MEFP has been completed.”

g. In paragraphs 5(a) and 5(b) of the ECF Arrangement the reference to “Table 3 of the November 2016 MEFP and further specified in the November 2016 TMU” shall be replaced with “Table 3 of the November 2017 MEFP and further specified in the November 2017 TMU”.

4. The Fund decides that the third and fourth review contemplated in paragraphs 4.A(b) and 4.B(b) of the ECF Arrangement is completed, and that the Democratic Republic of São Tomé and Príncipe may request the fourth and fifth disbursements referred to in paragraph 2(d) and 2(e) of the ECF Arrangement, notwithstanding the nonobservance of the end-December 2016 performance criteria on (i) the floor on domestic primary balance and (ii) the ceiling on changes in net bank financing of the central government, as set out in paragraph 4.A(a)(i) and (ii) of the ECF Arrangement, respectively, on the condition that the information provided by the Democratic Republic of São Tomé and Príncipe on the performance under these criteria is accurate, and on further condition that the information provided by the Democratic Republic of São Tomé and Príncipe on the implementation of the measure specified as a prior action in Table 4 of the November 2017 MEFP is accurate. (EBS/17/119, 11/28/17).

Decision No. 16294-(17/100), adopted
December 11, 2017

APPROVAL: February 12, 2019

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and Risks

1. ***Strong resolve is needed going forward to avoid further slippages and to safeguard the program's credibility and success. In this regard, could staff comment on how the current policy environment will avoid a repeat of the 2016 challenges, especially ahead of the July 2018 legislative elections?***
 - The revenue forecasts for 2017 and 2018 have taken into account the negative revenue developments in 2016 to avoid over-budgeting in advance and are projected conservatively. For instance, revenue yields from arrears collection are based on agreements reached with large enterprises and installments that have already been made. At the same time, the authorities have committed to hold back expenditure allocations until resources are available as they have done during the first 3 quarters of 2017. The staff will work closely with the authorities to monitor developments.
2. ***We also note that the authorities are in the process of redenominating the currency, and while appreciate that measures are being taken to raise awareness and promote a smooth transition, we invite staff comments on whether there might be any inadvertent impact of the redenomination on economic activity?***
 - The authorities are carrying out systematic public education and preparation for the transition. Given that the last three digits are usually "0" in current market prices, the inflationary impact from the rounding effect should be small, and the circulation of both currencies for 6 months should also help.
3. ***The staff project real GDP growth to average 5.5 percent over the medium-term, even though it has exceeded 5 percent only 4 times over the last 20 years and averaged 4.3 percent over the last decade. SPR has told the Board that economic growth forecasts used in DSAs for LICs have tended to be overly-optimistic, while the Risk Management Unit has also identified overly-optimistic forecasting, particularly in program countries, as a key risk. As a result, we would be interested in the confidence intervals around the 5.5 percent average growth forecast for Sao Tome and Principe.***

- The medium-term growth rate of 5.5 percent is projected with a reasonable degree of confidence and is subject to both downside and upside risks. Robust activity in construction, agriculture, and tourism spurred by externally-financed infrastructure projects, including the airport expansion and road construction will be the main drivers of growth. In addition, ongoing reforms to improve the business climate will help boost medium-term growth potential. Growth could be higher if externally financed infrastructure projects are implemented faster than programmed.

Fiscal Policy and Debt Sustainability

4. *We also note that additional measures are envisaged to counter the lower-than-expected tax revenues through end-August, with a view to reaching the program target for 2017 (a primary deficit of 1.8 percent of GDP, corresponding to 2.2 percentage points of adjustment). Actual and forecast growth does not seem to be affected by the extent of this projected fiscal tightening, remaining around 4 percent in 2016-17 and rising to 5.0 percent in 2018. Could staff elaborate on this performance, with any explanation of the implied low multipliers?*
 - While the primary domestic deficit, which excludes the large component of externally-financed expenditure and treats budget support grants as financing, is contracting, the overall primary fiscal deficit is stable in 2017 and expanding in 2018. The support of project grants and loan-financed investment for growth is also corroborated by imports of capital goods, which increased by 15 percent in the first 9 months of 2017.
5. *We also note that the DSA does not include arrears of state-owned EMAE to ENCO; these are admittedly outside the current perimeter of public debt and public-guaranteed debt, but could potentially impact debt sustainability. Could staff elaborate on the contingent liability risks of these arrears, and how such risks are being mitigated?*
 - The authorities are reforming the state-owned utility company EMAE with the support of the World Bank and European Investment Bank (EIB) to reduce the costs of production and improve financial management, with the goal of achieving cost recovery and hence reducing contingent liability risks. Meanwhile, the authorities have taken short-term measures to increase collection and cut cost.
6. *While we appreciate efforts to address revenue shortfalls, we would welcome clarity about the agreement reached between the government and some private businesses and state-owned enterprises on tax arrears. We are not clear how taxpaying entities are able to withhold and then negotiate payment of their tax obligations; is this consistent with the tax law? What is the implication of Article 74 of the tax law that*

is referred to in the MEFP (paragraph 17)?

- The tax arrears of ENCO to the government are part of the cross arrears: the state accumulated arrears to the utility company EMAE, which in turn failed to pay the oil importer ENCO for oil supplies. Based on a signed agreement with the government, ENCO has paid its arrears to the government in November.
 - Article 74 of the tax law allows for some deduction of PIT by individual taxpayers depending on their income and family makeup. The authorities have decided to suspend this law temporarily in 2018 to offset revenue shortfalls. The suspension will not affect vulnerable or poor households.
7. *We welcome the authorities' strong commitment to fiscal consolidation and containing fiscal risks, including the remedial actions taken to address end-2016 fiscal slippages and reform EMAE, as well as the measures they have identified to safeguard end2017 fiscal targets. Could staff provide more information on the capital expenditures that have been deferred as part of the latter effort (paragraph 14)?*
- The deferred capital expenditures were projects not yet started; the authorities noted that some of these projects can be financed by externally-financed projects to minimize impacts on the vulnerable population.
8. *Given that revenue underperformance has not been uncommon in São Tomé in recent years, could staff comment on implementation risks to the authorities' plans for closing the 2017 revenue gap, including relating to the expected receipt of import duties from ENCO?*
- As noted in the response to question 1, the revenue projections are conservative, and the authorities have committed to holding expenditure back until projected revenues materialize. As noted in the response to question 6, ENCO cleared its arrears in November.
9. *In the DSA report, the authorities suggest that under a customized scenario with large infrastructure projects, growth outcomes could be higher, leading to higher debt-carrying capacity and in this regard, they highlight the need to allow for adjustment of the indicative limit for concessional borrowing to finance critical growth-enhancing infrastructure projects. The staff may wish to comment.*
- The staff and the authorities agreed that it is important that the projected impact of investment be incorporated conservatively in the DSA. The staff also pointed out, that according to the Debt Limit Policy Guidance Note, the indicative limit for concessional borrowing can be adjusted to allow for projects which are key for

economic development, but these projects need to be chosen very carefully and based on solid feasibility studies.

10. ***We noticed that the effect of the PIT formula correction is negative, and the newly introduced consumption tax and alcoholic beverages duty did very little to increase fiscal revenue. We welcome staff's further elaboration on the reason for the weak tax performance, and how to diversify the financing channel for infrastructural construction.***
 - Weak tax administration is a major reason for poor revenue performance, an area that the authorities are working to improve with the assistance of the IMF and other international development partners. In 2017, weaker than expected revenue performance is also caused by a decline in imports of key commodities such as vehicles and lower than projected international oil prices. Reforms are ongoing to diversify and broaden the tax base, notably by introducing a VAT regime and strengthening tax administration and compliance. Other reforms that the authorities are implementing, such as improving the business environment to promote private sector development, should also help to broaden the tax base.
11. ***Does the IMF plan to provide TA to São Tomé and Príncipe for assessing the costs and benefits of foreign investments coming into the economy to ensure sustainability?***
 - The World Bank has helped the authorities to conduct feasibility studies of some large projects (such as airport expansion), and the Fund stands ready to assess the macroeconomic implications of specific large projects and provide TA in the Fund's competence area as needed. In the meantime, The staff has conducted and discussed with the authorities different scenario exercises regarding the potential implications of large projects on debt sustainability.
12. ***Can staff also comment on the efficacy of government expenditures and whether there are any diagnostics or TA planned to support the efficient use of donor resources?***
 - The World Bank is currently conducting a Public Expenditure Review that will help to improve the efficiency of public expenditure. The IMF, EU, World Bank, and AfDB are working with the authorities to improve public financial management.
13. ***Could staff provide further detail on the difficulties that the Sao Tomean economy has faced in implementing the VAT, which has been postponed several times despite their shortages in much needed fiscal revenue.***

- Implementation of the VAT requires a well-crafted law and adequate administrative capacity. With recent IMF TA, the adoption of a VAT law is on track to meet the rephased end-June 2018 benchmark. With support of recent IMF TA, a dedicated unit is being created to manage the transition to the VAT.
- 14. *Could staff expand on the growth impact this will have on the provided estimates for economic activity as well as the risks of not being able to reach the targets, specifically in expenditures?***
- (Please see answers to 4 and 1).

Monetary Policy and Financial Sector

- 15. *Regarding the monetary policy, we note that liquidity in the financial system remains high and inflation has accelerated in 2017. Although the central bank's anchor is the exchange rate, we would appreciate staff's comments on the monetary policy rate reduction in order to stimulate economic activity and the expected impact on consumer prices.***
- The authorities took the decision to reduce the reference rate by 100 basis points in June 2017 when inflation was decelerating. Because the policy rate has limited transmission to monetary aggregates, the impact on inflation is minimal. The uptick in prices, particularly since mid-2017, was transitory and related to domestic vegetable and fish production, which were negatively affected by more-than-usual rain.
- 16. *We note that domestic infrastructure for NPL resolution appears to be limited. Could staff comment on the expected timeline for the establishment of an out-of-court settlement mechanism, and whether there has been any discussion of other options to expedite NPL resolution, such as through the participation of an asset management company?***
- The establishment of Arbitration Centers for out-of-court settlements is progressing well. Specialized judges have already been identified and trained for the work, and the law that regulates the functioning of the centers has been approved. The next steps in the process include retrofitting the centers across the island, which should take place in the first quarter of 2018. The staff expects that the new mechanism could be functional by end-2018.
 - The staff does not favor the creation of an asset management company to dispose of bad assets from the banking system because of the associated cost and limited economies of scale in the country's small market.

17. *Despite a favorable economic outlook, slow credit growth remains. Could staff elaborate on the reasons behind this performance?*

- The still high NPL ratio, the difficulty of resolving NPLs, and infrastructural bottle-neck that constraints economic growth all contribute to the slow credit growth.

18. *The authorities have made improvements in strengthening financial soundness but the banking sector remains vulnerable. Could staff explain what led to the liquidation of Banco de Ecuador and what effect did it have on the banking system and if systemic risks remain.*

- Banco de Ecuador was intervened and put under Special Administration (SA) in January 2015. A transitional bank was created in 2016 but the central bank found that the two potential investors did not pass the fit-and-proper test. The banks' license was revoked on August 1, 2016 and it was put into liquidation. MCM provided TA to the liquidation process both in November 2016 and November 2017, including producing a comprehensive guide for all aspects of the liquidation.
- There has been no direct spillovers from Banco Ecuador's resolution to the rest of the banking system given the limited interbank interlinkages. The net proceeds of the liquidation will be used to reimburse the cost of closing the bank in accordance with the priority of claims provided for in civil law. The liquidation cost, largely in the form of payouts to small non-connected depositors, has so far not exceeded ¼ percent of GDP.
- The financial sector indicators have improved slightly, however, banking sector remains vulnerable. The central bank continues to strengthen banking supervision.

External Sector

19. *With the sharp uptick in imports in 2017, the current account deficit is expected to widen from 6 percent of GDP in 2016 to 12 percent of GDP in 2017. While the CAD is expected to be financed by FDI and external project loans, in view of past declines and uncertainties in external support, what are the fallback options in case inflows do not materialize?*

- FDI and external project grants/loans are the main drivers of increases in imports. A shortfall in FDI and external project grants/loans would be offset by lower imports of capital goods, and, consequently, a lower CAD.

20. *While we consider that fiscal consolidation can contain the widening of CAD, we would appreciate further comments by staff on the real effective appreciation of the dobra in 2016 and its respective impact on CAD.*
- The REER appreciation will have limited impact on the CAD in the short-run. Imports are mainly driven by FDI and external grants/loans, which are not affected by the REER. On the export side, the impact on country's main export goods, cocoa and tourism, is also limited, as the relatively high inflation is mainly caused by local food prices and the labor market has slack. In the forthcoming Article 4 consultation, staff plans to analyze this issue in more depth in the external balance assessment.

Structural Reforms

21. *It sets ambitious objectives, including achieving a sustainable growth rate of 5.5 percent and reducing poverty to 30 percent. What would be the time-span over which poverty is to be reduced to 30 percent and what steps will be taken for this?*
- (Please see answer to question 19)
22. *We urge the authorities to make economic growth much more inclusive as the poverty rate has remained over 65 percent since 2000 according to the staff's report. Could the staff further explain how the IMF-supported program will help in alleviating poverty?*
- The IMF-supported program seeks to strengthen public finances, reduce balance-of-payments vulnerabilities, and lay the foundation for stronger, more inclusive growth. The ongoing fiscal consolidation program is helping the authorities to reduce non-priority spending while protecting social expenditures and expanding high priority infrastructure investment. The program has also catalyzed donor support into poverty reduction initiatives. Other structural reforms to improve business climate, diversify the export base, and reform the energy sector will also help to promote broad based and inclusive growth.
23. *We welcome the new National Development Plan and its ambitious targets. Can staff advise if the goal to reduce poverty to 30 percent of the population is expected to be met by 2021 or if this is a longer-term objective?*
- The authorities have revised the target to 40 percent, taking into account comments from IMF and World Bank staffs. The goal of reducing poverty from 66 to 40 percent is expected to be achieved by 2021. To achieve the goal, the Plan outlined several interventions, including diversifying exports, improving the business climate, and human capital development. In particular, the government is currently working with

the World Bank to develop an export diversification strategy to achieve inclusive growth and promote employment through investment promotion. The strategy targets the tourism sector and high value horticultural production that are recognized as having the greatest potential.

Program Issues

24. *Could staff comment on what mechanisms are in place as early warning signals to spot deviations from program targets and trigger corrective actions, especially in light of past experiences?*

- As noted in the answer to question 1, staff will continue to work with the authorities to monitor progress, including examining monthly developments and quarterly indicative targets (see Table 3 of MEFP).

25. *We note that DPD target is at 1.8 percent of GDP for the whole year whereas the DPD reached 2.7 percent GDP in August on an annualized basis. These unsatisfactory outcomes result from the fact that the program had insufficient impacts in terms of Domestic Resources Mobilization so far. Tax revenue is expected at 13.4 percent of GDP in 2018, a level to compare to 14.3 percent of GDP reached in 2015. Against this background, could staff provide its assessment of the efficiency of IMF Technical Assistance on tax administration issues and Public Finance Management?*

- The IMF Technical Assistance on tax administration and public finance management provided an excellent roadmap for reforming these areas. To help the authorities to implement the reforms, follow-up hands-on support is being provided and is expected to continue. For example, a peripatetic advisor (funded by the Revenue Mobilization Trust Fund) has been helping the authorities to implement a VAT, and another short-term expert has conducted training for implementing VAT. The country recently joined AFRITAC central, which is expected to provide more hands-on TA.

26. *Can staff please elaborate on the specific constraints and reasons for the delays in Fund TA provision?*

27. *We note that the mixed implementation of structural reforms under the program is due mainly to capacity constraints and delays in the delivery of technical assistance. Could staff comment on the reasons behind these delays, and what steps have been taken to ensure timely delivery of TA in support of program objectives?*

- The country has received a lot of IMF TA as noted in the informational annex. The delay is related to some TA, on which the IMF is facing a large demand with limited

resources. As noted in the report, the World Bank is planning to provide Public Investment Management Assessment.

- With continued provisioning of TA, progress has been made. For instance, the rephrased structural benchmark on adopting a VAT law is no track as a result of IMF TA, including peripatetic expert visits, training, and assistance in drafting the law.
- 28. *The staff reports that due to capacity constraints and delays in technical assistance, programmed fiscal reforms are proceeding slowly. Could staff comment if TAs are planned in the short run for São Tomé and Príncipe to assist in overcoming future setbacks and to secure results?***
- (Please see answer to question 25-27).