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Cape Verde: Letter of Intent, Memorandum of Economic and
Financial Policies, and Technical Memorandum of Understanding

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The following item is a Letter of Intent of the government of Cape Verde, which describes the policies that Cape Verde intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Cape Verde, is being made available on the IMF website by agreement with the member as a service to users of the [IMF](#) website.

July 11, 2006

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
700 19th Street N.W.
Washington D.C. 20431

Dear Mr. de Rato:

1. In July 2005, the government of Cape Verde completed its first arrangement with the IMF under the Poverty Reduction and Growth Facility (PRGF). Put in place against the backdrop of severe macroeconomic imbalances that Cape Verde faced in 2001, the PRGF-supported program emphasized a strengthening of the fiscal position, an increase in international reserves, and a wide range of structural reforms. Overall results under the program were considerably better than expected, as reflected in the significant improvements that Cape Verde has experienced in terms of macroeconomic performance, policy credibility, and external financial support.
2. Looking ahead, the government is seeking to maintain a close policy dialogue with the IMF under the Policy Support Instrument (PSI). The government believes that Cape Verde is well-suited to the PSI: macroeconomic stability has been achieved; financial resources from the Fund are not needed; but the PSI would support the government's ongoing efforts to strengthen policy performance and signal its commitment to sound policies to the international community.
3. The attached Memorandum of Economic and Financial Policies (MEFP) sets out the government's economic goals and policy framework for 2006–09, for which it requests support under the three-year PSI. Key elements of this program include a reduction in government debt, a further increase in international reserves, and structural reforms to improve public sector management, reduce fiscal risks, and strengthen the financial sector.
4. Under the three-year PSI, the government will keep the IMF regularly updated on economic and policy developments and will provide the data needed for adequate monitoring of the program—including in the context of the twice-yearly reviews. During the period of this Instrument, Cape Verde will consult with the IMF on the adoption of any measures that may be appropriate at the initiative of the government, or whenever the Managing Director of the IMF requests such a consultation.
5. We authorize the IMF to publish this letter and the attached MEFP and the related staff report.

Sincerely yours,

/s/

João Pinto Serra
Minister of Finance and Public Administration

ATTACHMENT I

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES OF THE
GOVERNMENT FOR 2006–09

I. INTRODUCTION

1. This memorandum summarizes the government of Cape Verde's economic objectives and policy framework for 2006–09, for which the Government is seeking support from the International Monetary Fund under the Policy Support Instrument (PSI). The government believes that Cape Verde is well-suited to a PSI. The economy is stable; IMF financial resources are not needed; but the Government would like to maintain a close dialogue with the Fund—both to support the ongoing strengthening of economic and policy performance, and to signal to the international community the authorities' commitment to maintain sound economic policies. The policies described are consistent with Cape Verde's Poverty Reduction Strategy Paper (PRSP), which sets out the country's medium-term development priorities.

2. **The PSI program described in this memorandum builds on the strong results that Cape Verde achieved in its previous arrangement with the IMF under the Poverty Reduction and Growth Facility (PRGF) arrangement**, which ended in July 2005. The economic strategy under the PRGF arrangement emphasized the need for fiscal consolidation, involving both restraint in public spending and improvements in revenue performance, in order to correct the severe macroeconomic imbalances that emerged in 2000–01. The strengthening of the fiscal position since 2001 has supported a large build-up in international reserves and growth of overall policy credibility. Reflecting these improvements in the policy environment, Cape Verde has experienced sizable inflows of external finance for investment and development, solid growth averaging around 5 percent over 2001–05, low inflation, and a reduction in poverty.

3. **While recent economic performance has been strong, Cape Verde continues to face large development challenges.** Unemployment and poverty remain high despite recent progress; and improving infrastructure, public services, and other underpinnings of sustainable growth and poverty reduction across many small islands is inherently slow and costly. For example, reaching the Millennium Development Goals in areas such as health, education, and sanitation will place major pressures on public spending to strengthen infrastructure and the volume and quality of services. To address these and other challenges, Cape Verde will continue to rely heavily on external support. The government also notes with concern that, despite its strong record of governance and policy performance, Cape Verde has not been deemed eligible for external debt relief under recent multilateral initiatives. To help redress this apparent incongruity, the government calls on the international community to continue to support growth and development in Cape Verde over the long term through grants and highly concessional financial assistance.

II. RECENT ECONOMIC DEVELOPMENTS

4. **The Cape Verde economy continues to perform well.** Preliminary economic indicators point to a pick-up in growth in 2005 to an estimated rate of around 6 percent. Inflation averaged only 0.4 percent in 2005, but has increased recently—mainly as a result of higher food and petroleum prices. Supported by prudent fiscal performance in 2005, international reserve accumulation has been strong, reaching 3.0 months of prospective imports in December 2005. Commercial banks' excess reserves increased substantially in 2005, a result of strong capital inflows, a lowering of the reserve requirement, and a slowdown in private sector credit growth in the first part of the year. In response, the Bank of Cape Verde (BCV) has sold securities to partially absorb the increase in liquidity.

5. **The government has been moving forward with its structural reform agenda.** A new management team has been selected to restructure the national airline TACV in preparation for its privatization, and the bidding process is getting under way for privatization of the port operator ENAPOR. The authorities have completed a detailed action plan to build capacity in public finance management, and has established a civil servants database to support analysis of the current workforce and proposals for further civil service reform. Steps have been taken to clear the backlog of government accounts: the draft accounts for 1998–2003 have been completed and submitted to parliament for transmittal to the Court of Auditors (TdC). Provisional quarterly accounts for 2004 and 2005 have also been submitted to the parliament.

6. **Thanks to sound governance and good economic performance, Cape Verde is attracting significant international support, both official and private, for investment and development.** Cape Verde was one of the first countries to receive support from the Millennium Challenge Account (MCA) in 2005. The amount of US\$110 million will be disbursed in the next five years to finance growth in the country's physical and human capacities. Cape Verde has been deemed eligible for further support from the MCA under a new category created for lower middle income countries. Private investment inflows, directed largely toward the construction sector and tourism, remain strong, as evidenced by a large increase in the rate of project approvals during 2005.

7. **Financial services continue to develop rapidly.** The banking sector's total assets have grown by 20 percent since end-2004 to reach over 90 percent of nominal GDP, with growth heavily concentrated in the construction sector. Emigrant deposits, accounting for over 40 percent of total deposits, continue to play a critical role in the banking sector. The profitability of the banking sector suffered significantly in 2005, owing to a tightening in interest spreads and the excess liquidity noted above, although prudential indicators remain sound. The rapidly developing offshore banking sector in Cape Verde now includes four operational offshore banks, with four other banks and two parabanking companies already licensed but not yet operational. Among recent developments in the financial sector is an ongoing project to create a centralized credit bureau that would help lenders assess the basic creditworthiness of borrowers, thus enhancing access to credit and the overall credit culture. The Cape Verde stock exchange (Bolsa de Valores de Cabo Verde) is seeing a revival in activity, including daily trading of government bills and a small number of corporates.

III. MEDIUM-TERM OBJECTIVES AND STRATEGY

8. **The Government's medium-term objectives and strategy are set out in the PRSP and other national planning documents, and have been reiterated and elaborated recently in the Government Program for 2006–11.** This strategy is directed at boosting growth and reducing poverty through private sector-led development and diversification of economic activities. In support of these goals, the Government's policy priorities include (i) building human capacities through improving access to education, training, and health care; (ii) strengthening infrastructure and institutions, including to support service sector growth in areas such as tourism, financial services, and communications; and (iii) improving governance and the capacity of the public sector to implement policy reforms and program mandates.

9. **The program to be supported by the PSI aims to provide a consistent and coherent economic policy framework to underpin the Government's medium-term development objectives.** In particular, the program focuses on enhancing the sustainability of growth and development by maintaining a stable macroeconomic environment and moving forward with structural reforms, especially in areas that have systemic significance for the economy. Specific attention is given to reducing fiscal risks and to providing Cape Verde with an adequate safety margin to help protect the economy against exogenous shocks. The macroeconomic framework would also help prepare Cape Verde for the prospect that, as the level of GDP per capita continues to rise, the country's access to highly concessional external finance may diminish.

10. **Key policy measures in the program include:**

- increasing foreign exchange coverage to further strengthen the credibility and resilience of the exchange rate peg;
- decreasing the burden of domestic debt and clearing remaining domestic arrears;
- strengthening public finance management capacity, expenditure control, and revenue performance;
- pursuing structural reforms to reduce fiscal risks and support efficiency improvements in the economy;
- regulatory reforms to ensure that financial sector development takes place within a sound institutional framework.

Outlook for growth and inflation

11. **The government's goal is that, as the human and physical capacities of the Cape Verde economy continue to build, growth should move up to double digit levels.** Macroeconomic and structural policy measures addressed under the PSI program will help lay the groundwork for attaining this longer-term growth objective. While economic activity in 2006 will be affected by the impact of higher international oil prices, growth is expected to

pick up in the years ahead and average 6–7 percent during the PSI program. Strong private investment in the tourism sector and public investment in infrastructure, complemented by the ongoing development of domestic capacities, will continue to provide the key support for growth. Following an upward move in inflation over 2006–07, driven in part by sharp adjustments in regulated prices following increases in international oil prices, consumer inflation is expected to stabilize at 2–3 percent over the medium term in line with rates in the euro area.

Fiscal policy and structural reforms

12. The medium-term fiscal strategy will be geared towards preserving macroeconomic stability, reducing risks, and creating fiscal space to prepare for potential future pressures on the budget. For example, fiscal pressures may arise from government liabilities to the public pension system as this develops and matures; from growth in demand for other public services; from the possibility that Cape Verde's access to highly concessional external support may diminish as the country moves further into middle income status; and, associated with the last point, from the prospective need for increased domestic capital participation in public investment projects. To support its fiscal and macroeconomic objectives, the government intends to reach and then maintain a central government debt ratio of no more than 70 percent of GDP. This goal would be attained under the medium-term program to be supported by the PSI through further reductions in both domestic and external debt as a share of GDP. Furthermore, with external financing largely directed toward the public investment spending, which has a high import content, the government recognizes that ongoing restraint in current spending and domestic borrowing will play an important role in supporting the desired increase in international reserves as well as the debt reduction objective. Hence, in the medium-term program, government domestic debt would be targeted to reach around 20 percent of GDP by 2009 (from over 33 percent at end-2005). In the scenario set out in the statistical tables, this objective would be consistent with further growth of capital spending, with net domestic borrowing that is in tandem with the program to clear old arrears, and with the creation of increasing fiscal space to meet pressures such as those noted above¹.

13. **This fiscal stance would allow external debt to be lowered from 56 percent of GDP in 2005 to 49 percent in 2009.** The deficit will be driven primarily by the availability of highly concessional external loans for financing the government's public investment program. If any external debt is contracted or guaranteed by the central government on terms falling below the 35 percent concessionality threshold (as set out in the attached Technical Memorandum of Understanding), the total of this new nonconcessional external debt and guarantees will be held to no more than US\$20 million per year (around 2 percent of GDP). To ensure that this and other borrowing remain consistent with its debt sustainability objectives, the government is seeking assistance from its international partners to support the strengthening of both debt management practices and project appraisal capacities.

¹ The fiscal methodology used in the statistical tables follows that set out in the 2001 GFS Manual, which the government intends to fully adopt as rapidly as possible. The government requests technical assistance from the IMF in support of this change.

14. **In support of these fiscal objectives, the government will continue to contain nonpriority current expenditures, improve the mobilization of domestic revenues, and limit contingent and quasi-fiscal liabilities.** Within the constraints imposed by revenue availability, expenditures will be prioritized in line with the PRSP objectives. The government's recent decision to end all energy subsidies, announced as part of the 2006 budget, represents an important step toward reducing expenditure pressures, strengthening budget management, and creating fiscal space for higher priority spending—including well-targeted measures to support those in need. The expenditure restraint necessary to achieve government's overall fiscal goals will nevertheless allow a substantial increase in government investment, which is expected to remain around 16 percent of GDP over 2006–09, up from 13 percent in 2005. Lower interest expenditures as the debt declines will support the redirection of spending toward the public investment program and other poverty reduction efforts.

15. **The government recognizes that the full clearance of arrears is essential to restore order in the public finances and ensure the credibility of government as a diligent economic agent.** A recent study assessed the extent of public cross-debt involving central government, municipalities, the social security fund (INPS), and public and parapublic enterprises. Following this study, the government has agreed to settle 4.8 billion CVEsc (equivalent to 5.5 percent of GDP) in several installments. The government has also paid part of its old arrears to the oil companies for past subsidies on fuel supplied to Electra. The government is firmly committed to repaying remaining arrears and staying current on all its payment obligations throughout the program and beyond. To prevent a recurrence of the arrears buildup that has occurred among municipalities and autonomous public agencies, including their failure to remain current in payments for energy and other inputs, the central government will work directly with these entities to strengthen their financial management capacities and practices. If the arrears problem persists despite these efforts, the central government will take direct measures to assert fiscal discipline; for example, such measures may include government meeting energy payments on their behalf, and deducting the corresponding amounts from government transfers to the entities concerned.

16. **The government will maintain its efforts to reinforce and strengthen revenue collection.** Tax reforms over recent years, including the introduction of VAT and streamlining of import and consumption taxes, have made a substantial contribution toward reducing economic distortions, improving the transparency of the tax system, and strengthening overall revenue performance. In the PSI program, the government will give particular attention to pushing ahead with improvements already underway in revenue administration, and to further widening the tax base through rationalization of tax incentives and exemptions. In both areas, assistance has been provided by the IMF Fiscal Affairs Department (FAD). Following FAD advice, the complex system of tax exemptions will be reformed to ensure that exemptions will be granted only according to clearly defined economic criteria that correspond to the national development strategy, and regulated under a single law that will abolish the multitude of scattered norms currently in place. As noted below, these reforms will be part of the 2006–07 program.

17. **Additional structural measures will be taken to help contain fiscal risks and reinforce the macroeconomic targets set out above.** Reform efforts will include:

- improving the productivity of the civil service;
- strengthening capacities and procedures for formulating, executing, monitoring, and auditing the budget; and
- implementing a clear strategy for supporting production of electricity and water, including the automatic tariff adjustment mechanism.

18. **The government is determined to move ahead with reforms to public administration.** These reforms will focus on improving civil service capacities and productivity within the constraints of the overall wage bill. The government will give particular attention to ensuring that staffing levels are consistent with departmental requirements, and that wage structures provide appropriate incentives for performance and for the recruitment and retention of qualified staff, without putting undue pressure on private sector wages. In preparing for reform and rationalization of administrative structures, and following guidelines issued by the Council of Ministers, the Ministry of Finance and Public Administration has issued a circular requiring section heads in government departments to submit to the Directorate-General of Public Administration a list reflecting staffing needs and personnel available for mobility. Supporting these reform efforts will be the new civil servants database, recently established with the help of the World Bank. The above circular also mandates that Autonomous Funds, Autonomous Services, and Public Institutes that fail to submit the requested information will not receive monthly transfers. The government has imposed a freeze on promotions in public administration while it takes stock of reform requirements and directions. To further tighten fiscal control, the Public Treasury will not be responsible for meeting the costs of staff contracted by local health and education authorities in excess of budget limits.

19. **The government's public sector reforms include a wide range of measures to strengthen the budget process, from the formulation stage to final audit.** Some specific measures are discussed below in the program for 2006–07. These reforms are shaped in part by the Country Financial Accountability Assessment (CFAA) action plan, which the authorities are implementing with the support of the World Bank, the Netherlands, and other donors. Key steps in this area include developing a new national plan of public accounts, introducing a medium-term expenditure framework, strengthening public sector procurement practices, and introducing a new fiscal register. The recently developed SIGOF system provides a highly effective tool for real-time control of budget execution and monitoring, and the government intends to support the further development of this system and its expansion to other parts of the public sector. The authorities are seeking additional external assistance to move ahead with these initiatives.

20. **The government's energy policy is focused on supporting improvements in the quality of life of Cape Verdeans, improving the economy's competitiveness, ensuring stable supplies of energy, and preserving the environment.** This policy is directed in part at promoting conservation and alternative energy sources to reduce Cape Verde's dependence on oil imports. To address persistent and growing concerns about service quality, especially concerning supplies of electricity and water, an integrated approach is needed

involving the strengthening of the regulatory environment for the sector and increased investment in production and distribution. In particular:

- As part of its overall energy strategy, the government intends to strengthen legal and regulatory structures to support a competitive energy market, safeguard consumers, and increase discipline and transparency. In support of these measures, the government will reinforce institutional capacities for energy administration and develop a specific legal and regulatory framework for the subsector of electricity and fuel.
- ARE, the autonomous economic regulatory authority, has full authority to establish a tariff policy that both reflects costs and provides incentives for gains in efficiency. This policy needs to take into account the government's recent elimination of fuel subsidies, and to include full implementation of the automatic mechanism to adjust tariffs in light of changes in input costs and efficiency gains. ARE has guaranteed to the government that these requirements will be met by June 1, 2006.
- Investment in energy infrastructure is essential to increase efficiency and to ensure wider and easier access of the population to energy and water services. The government seeks the full cooperation and commitment of Electra to implement its investment plan for improving production and distribution. The government also calls on donor support to ensure that progress is made in this area.

Monetary policy and financial sector reforms

21. **Medium-term monetary policy will be geared, as in the past, towards safeguarding the exchange rate peg with the euro as an anchor for low inflation.** In order to provide a further cushion against external shocks and underpin investors' confidence into the peg, macroeconomic policies under the PSI program will be designed to support a further build-up of international reserves of at least 0.1 months of prospective imports per year—equivalent to around ½ percent of current GDP. Drawing on technical assistance from the IMF, the authorities will also strengthen the operational framework for monetary policy, including the development of intermediate monetary indicators to guide liquidity management and other dimensions of policy conduct. In-house capacity for tracking large external capital flows will be built, including to gauge the interest sensitivity of emigrant deposits and other private flows.

22. **In strengthening the financial sector, the government is committed to a wide ranging set of measures which, among other aspects, will ensure that the regulation and supervision of financial institutions, including International Financial Institutions (IFIs), is in line with best international practice.** Initiatives in this area will be guided by an Action Plan being drafted by a multidisciplinary task force organized by the BCV. Among other inputs, the task force will consider the recommendations of a November 2005 technical assistance mission from the Monetary and Financial Systems Department (MFD) of the IMF. The authorities will ensure in particular that there is sufficient growth in institutional

capacities for regulation and supervision of the financial sector. Furthermore, development of IFIs will be taken at a careful pace, with proper measures in place to protect the system against potential financial abuse and to safeguard Cape Verde's reputation and access to the international financial system. To the extent that IFIs engage in transactions with residents, these activities take place under the same prudential standards as apply to domestic banks. In the context of developing the legislative and institutional framework, including for anti-money laundering and combating the financing of terrorism (AML/CFT), the authorities will seek to bring this framework into line with international standards. In this regard, the Action Plan and all relevant activities therein will be discussed with the stakeholders and the donor community to ensure its adequacy and to secure technical and financial support for its implementation.

23. **The authorities will look further into obstacles to growth in bank lending to the private sector.** Reducing the cost of capital will be an important goal of monetary policy and financial sector development in the next few years. Growth of credit to the private sector will be further supported by enhancing the regulatory and legislative framework to protect lenders and strengthening banks' capacity to provide project-based lending. Reforms in the financial sector will also aim to improve credit risk management, expand access to credit for SMEs, and increase competition in the financial market.

Other structural reforms

24. **In parallel with the fiscal and financial sector measures outlined above, the government plans to implement ambitious reforms to enhance competitiveness, strengthen the business environment, and hence promote private sector led growth.** Against this background, trade reforms are proceeding in the context of WTO accession, for which a decision is expected during 2006; labor market reforms are being discussed with the goal of increasing the economy's capacity to create jobs and improving working conditions; a modern regulatory framework has been drafted in order to advance with the liberalization of the telecom market; and administrative barriers to private sector initiatives are being removed, including by the introduction of modern information technology in the provision of public services under the e-government initiative.

IV. POLICIES FOR 2006–07

25. **Within the general medium-term strategy described above, the government has specific policy targets it plans to meet in 2006–07.** These policies are intended to underpin a sustained pickup in growth and reduction in inflation following the short-term impact of increases in regulated prices during 2006.

Fiscal measures

26. **In addressing some key sources of fiscal concern, including eliminating subsidies and clearing arrears, the 2006 budget has taken important steps toward supporting the medium-term macroeconomic strategy of the PSI program.** Policies for 2007 will be geared toward further strengthening the fiscal position. Consistent with the objective of reducing domestic debt to 20 percent of GDP by 2009, government net domestic borrowing

will be limited to at most 0.8 percent of GDP in 2006 (contributing to budgeted arrears clearance of 1.7 percent of GDP) and 0.9 percent in 2007 (in line with arrears clearance anticipated in 2007). As a result, domestic debt, net of deposits but including arrears, is projected to decline from 32.7 percent of GDP at end-2005 to 25 percent at end-2007.

27. **To support these fiscal goals, the government is committed to ongoing restraint of current spending, combined with structural reforms to improve revenue performance, reduce fiscal risks, and improve financial management.** Specific measures the government plans to implement in 2006–07 include:

- **Rationalizing and streamlining tax incentives and exemptions.** As discussed above, the currently complex and fragmented approach to granting exemptions will be reformed, with exemptions granted instead according to clearly defined economic criteria and regulated under a single law. To effect these reforms, the government intends to submit draft legislation to the National Assembly by mid-2007.
- **Implementing the automatic mechanism to adjust electricity and water tariffs in line with changes in input costs and efficiency gains.** As noted above, ARE has guaranteed it will implement this mechanism by June 1, 2006.
- **Completing the privatization agenda.** Among the few enterprises remaining on this agenda, privatization of EMPROFAC (a pharmaceuticals distributor), ENAPOR (the port operator), and INTERBASE (a fish freezing company) is expected within 2006. A new management team will restructure TACV (the national airline) under a one-year consultancy contract beginning in June 2006, and privatization is expected in 2007.
- **Establishing a macroeconomic policy unit in the Ministry of Finance and Public Administration.** The government recognizes that such a unit is needed to improve the formulation of fiscal policy and its coordination with overall macroeconomic objectives. A unit will be established and staffed by December 2006.
- **Strengthening internal and external audit processes.** Priorities for the first year of the program will be the completion and implementation of the laws on reorganization and mandates of the TdC, and the National Chart of Public Accounts.

Monetary and financial sector policies

28. **Complementing these fiscal efforts, monetary policy during 2006–07 aims at further enhancing the credibility of the exchange rate peg.** Gross international reserves of the BCV are programmed to increase by CVEsc 2.1 million in 2006 and 2.3 million in 2007 (to 3.2 months of prospective imports). The reduction in growth of net credit to the central government should allow for an expansion in credit to the private sector in the range of 14 percent in 2006 and 2007, while broad money is expected to expand in line with nominal GDP growth. The central bank is committed to actively utilizing the monetary instruments at

its disposal (including required reserves, its standing facilities, and open market type operations) in order to control liquidity and achieve the monetary targets established under the program. The program ceilings on net domestic assets of the BCV are set out in Table 1. The BCV will also move forward during 2006–07 in tracking gross inflows and outflows of emigrant deposits to support its analysis of the interest sensitivity of these flows.

29. Measures to strengthen the financial sector in 2006–07 will draw on the recommendations of the task force noted above. Over 2006–07, priorities include:

- continuing to expand the institutional capacity of the BCV to conduct supervision;
- signing formal information sharing agreements with home country supervisors of subsidiaries and branches established in Cape Verde;
- reviewing and reforming as necessary the legislative and regulatory framework of IFIs in light of the task force report, including licensing procedures and criteria (especially for autonomous companies), secrecy provisions, and branching into third countries; and
- amending as necessary the AML/CFT legislation to bring it at par with the 2003 FATF/CFT standards.

The authorities are committed to addressing these priorities by mid-2007.

V. PROGRAM MONITORING

30. Program implementation will be monitored according to assessment criteria and benchmarks presented in Tables 1 and 2 (attached). The definitions of the variables monitored as quantitative assessment criteria and benchmarks are contained in the Technical Memorandum of Understanding (attached). The program will also include, as assessment criteria, the equivalent of the standard performance criteria concerning the exchange and trade system that apply in Fund financial arrangements. Program implementation and the economic results associated with the program will be subject to two reviews per annum. The first review will be expected to be completed by end-November 2006 based on end-September 2006 assessment criteria and benchmarks, the second by end-February 2007 based on end-December 2006 criteria, and the third review by end-August 2007 based on end-June 2007 criteria. Reviews will proceed on a half-yearly basis thereafter. The quantitative criteria will be monitored on a quarterly basis.

Table 1. Cape Verde: Quantitative Assessment Criteria and Benchmarks for 2006–07 Under the PSI^{1, 2}

	2005 Dec. Level Actual	Cumulative flows from End-December 2005				Cumulative flows from End-December 2006			
		2006				2007			
		March Indicative target	June Indicative target	Sep. Assessment criteria	Dec. Assessment criteria	March Indicative target	June Indicative target	Sep. Indicative target	Dec. Indicative target
(billions of Cape Verde escudos)									
Ceiling on net domestic borrowing of the central government ³	...	...	-0.9	-1.4	-1.8	-0.1	-0.1	-0.2	-0.2
Ceiling on net domestic assets of the central bank ³	5.8	...	-0.4	-0.6	-0.9	-0.2	-0.4	-0.6	-0.8
Ceiling on the accumulation of new domestic payment arrears by the central government	5.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(Millions of U.S. dollars)									
Ceiling on the accumulation of new external debt arrears by the central government ⁴	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Ceiling on the contracting or guaranteeing of non-concessional external debt with original maturity of more than one year by the central government ⁵	...		10.0	10.0	20.0	5.0	10.0	15.0	20.0
Ceiling on the outstanding stock of nonconcessional external debt with a maturity of less than one year by the central government ^{4, 6}	0.0	0.0	0.0	...	0.0	0.0	0.0	0.0	0.0
(Millions of euros)									
Floor on net international reserves of the Bank of Cape Verde (BCV) ⁷	137.0	...	9.5	13.8	19.0	5.2	10.4	15.2	20.9
(Billions of Cape Verde escudos)									
Program assumptions									
Nonproject external financial assistance, including credit line (program assumption)	...	...	1.6	2.3	3.1	0.5	1.0	1.6	2.1
External debt service	...	...	1.4	2.1	2.8	0.7	1.4	2.1	2.8
Clearance of end-2005 stock of domestic arrears	5.3	...	-0.9	-1.3	-1.7	-0.3	-0.6	-0.9	-1.2

¹ Quantitative assessment criteria and benchmarks are described in the technical memorandum of understanding.

² For purposes of calculating program adjusters, foreign currency amounts will be converted at current exchange rates.

³ Excluding borrowing for clearance of arrears and net late payments. The ceiling will be adjusted downward (upward) by the cumulative downward (upward) deviations in external debt service and upward (downward) by the cumulative downward (upward) deviations in nonproject external financial assistance relative to program assumptions.

⁴ This assessment criterion is on a continuous basis.

⁵ This assessment criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85), August 24, 2000), but also commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are rescheduling arrangements, the Portuguese credit line, and borrowings from the Fund.

⁶ The term "debt" has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt. Excluded from this performance criterion are rescheduling arrangements, the Portuguese credit line, borrowings from the Fund, and normal import-related credits.

⁷ The floor on net international reserves of the Bank of Cape Verde will be adjusted upward (downward) by exchange valuation gains (losses), by the cumulative downward (upward) deviations in external debt service, and downward (upward) by the cumulative downward (upward) deviations in nonproject external financial assistance relative to program assumptions.

Table 2. Summary of Structural Conditionality for 2006–07

Objectives	Conditionality	Timing
Structural Assessment Criteria		
Reduce fiscal risks	Complete implementation of the automatic utility tariff adjustment mechanism	End-September 2006
Structural Benchmarks		
Strengthen financial regulations	Complete Action Plan of task force assessing measures to ensure that financial sector regulation and supervision is in line with best international practice, including provisions applying to IFIs and AML/CFT	End-September 2006
Strengthen fiscal strategy	Establish macroeconomic policy unit in the Ministry of Finance and Public Administration	End-December 2006
Strengthen financial supervision	Sign formal information sharing agreements with home country supervisors of subsidiaries and branches established in Cape Verde	End-December 2006
Improve budget prioritization	Implementation of the MTEF	End-June 2007
Strengthen financial regulations	Implement recommendations of task force on financial sector reform (see above)	End-June 2007
Streamline tax incentives	Submit draft legislation to National Assembly on streamlining of tax incentives and exemptions	End-June 2007
Strengthen fiscal control	Implement laws to strengthen the Court of Auditors (TdC) and National Chart of Public Accounts	End-June 2007

ATTACHMENT II

CAPE VERDE

TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This memorandum sets out the understandings between the Cape Verdean authorities and the IMF staff regarding the definition of assessment criteria and indicative targets and reporting requirements under the first annual program supported by the Policy Support Instrument.

I. QUANTITATIVE ASSESSMENT CRITERIA AND INDICATIVE TARGETS

A. Net Domestic Borrowing Excluding for Clearance of Arrears and Net Late Payments

2. **Net domestic borrowing excluding for clearance of arrears and net late payments** is defined as the cumulative change since the start of the calendar year of the net credit to the central government from the banking and nonbanking sectors less (1) the cumulative clearance during the calendar year of the stock of arrears as of end-2005 and (2) the cumulative payments during the first three months of the calendar year of expenses authorized by the previous year's budget, and plus the expenses accrued during the current year that will be paid during the first three months of the next calendar year as provisioned for in the budget law (late payments or *atrasados*). The ceiling will be adjusted downward (upward) by the cumulative downward (upward) deviations in external debt service and upward (downward) by the cumulative downward (upward) deviations in nonproject external financial assistance relative to program assumptions.

3. **Net credit to the central government from the banking and nonbanking system** is defined as the overall position of the main central government institutions vis-à-vis the banking and nonbanking system—that is, the stock of all outstanding claims on the central government (loans, advances), and all other government debt instruments, such as long-term government securities) held by the central bank, commercial banks, and nonbank institutions, less all deposits held by the central government with the central bank and with commercial banks. The INPS is not included in central government accounts. Net credit to the central government excludes claims on the Trust Fund (TCMFs).

4. **Reporting requirements.** Data on the implementation of the budget compiled by the Ministry of Finance and Economic Planning will be provided on a quarterly basis, to be submitted not later than five weeks after the end of each quarter, including (i) government domestic revenue by category; (ii) external budget support grants; (iii) government expenditure, including primary current expenditure, domestic and external interest payments, and capital expenditure, including domestically and budget support financed capital expenditure and estimates of externally project financed capital expenditure; (iv) the gross payment and gross accumulation of domestic accounts payable (*atrasados*); (v) the gross

payment and gross accumulation of domestic payments arrears; (vi) external loan receipts and principal payments; (v) external arrears payments and accumulation; (vii) bank and nonbank financing; (viii) privatization and land sale receipts; and (ix) any other revenue, expenditure, or financing not included above.

5. For the purposes of this memorandum, privatization and land proceeds will be understood to mean all monies received by the government from the sale or concessioning of a public company, organization, or facility to a private company or companies, organization(s), or individual(s), as well as any proceeds generated from the sale of government land and the liquidation of a public company, less restructuring costs.

B. Net Domestic Assets of the Central Bank

6. The ceiling on the cumulative change, from the beginning of calendar-year 2006, in net domestic assets of the BCV constitutes an assessment criterion. Net domestic assets (NDA) of the BCV are defined as reserve money minus net foreign assets of the BCV, evaluated at the current end-of-period exchange rates. The program ceilings for NDA will be adjusted downward (upward) by the cumulative downward (upward) deviations in external debt service and upward (downward) by the cumulative downward (upward) deviations in nonproject external financial assistance relative to program assumptions. For purposes of calculating the adjusters, these flows will be valued at current exchange rates. Reserve money comprises bank reserves and deposits of the monetary institutions and private sector with the central bank, as well as cash in circulation.

7. **Reporting requirements.** The preliminary monthly balance sheets of the BCV and the consolidated commercial banks will be transmitted on a monthly basis, with a maximum delay of five weeks. The definitive version of the monthly balance sheet of the BCV will be provided as soon as available.

C. Ceiling on Nonconcessional External Debt Contracted or Guaranteed by the Central Government

8. Under the program, ceilings on medium- and long-term, as well as on short-term, nonconcessional external debt constitute assessment criteria. These assessment criteria are on a continuous basis. Nonconcessional external debt is defined as debt contracted or guaranteed by the central government with a grant element of less than 35 percent, calculated using currency-specific commercial interest reference rates (CIRRs) published by the Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD). Debt rescheduling and debt reorganization are excluded from the limits on nonconcessional external debt. The limits on new nonconcessional external debt contracted or guaranteed by the central government (excluding borrowing from the Fund) are specified in Tables 1 and 2 of the memorandum of economic and financial policies. The definition of short-term nonconcessional external debt excludes normal short-term (less than one year) import-related financing. The Portuguese government's precautionary credit line in support of the exchange rate peg is also excluded from the definition of nonconcessional external debt. In addition, the central government will not guarantee any external debt contracted by state enterprises and will maintain the policy of not guaranteeing private sector external debt.

The assessment criterion on medium- and long-term nonconcessional external indebtedness applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85), 8/24/00) but also to commitments contracted or guaranteed for which value has not been received. With respect to the assessment criterion on short-term nonconcessional external indebtedness, the term “debt” has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85), 8/24/00).

9. **Reporting requirements.** The government of Cape Verde will consult with Fund staff before assuming any liabilities in circumstances where they are uncertain whether the instrument in question falls under the assessment criterion. Details of all new external debt (including government guarantees), indicating terms of debt and creditors, will be provided on a quarterly basis within five weeks of the end of each quarter.

D. Net International Reserves of the Central Bank

10. The floor on the cumulative change, from the beginning of calendar-year 2006, in net international reserves (NIR) of the BCV constitutes a assessment criterion under the program. The NIR of the BCV are defined as gross international reserves of the BCV net of its external reserve liabilities, calculated at the current exchange rates. Gross reserves of the BCV are those that are readily available (i.e., liquid and marketable and free of any pledges or encumbrances), controlled by the BCV and held for the purposes of meeting balance of payments needs and intervening in foreign exchange markets. They include gold, holdings of SDRs, the reserve position at the IMF, holdings of foreign exchange and traveler’s checks, demand and short-term deposits at foreign banks abroad, fixed-term deposits abroad that can be liquidated without penalty, and any holdings of investment-grade securities. External liabilities of the BCV comprise liabilities to nonresidents contracted by the BCV with an original maturity of less than a year, any net off-balance-sheet position of the BCV (futures, forwards, swaps, or options) with either resident and nonresidents, any arrears on principal and interest to external creditors and suppliers, and purchases from the IMF. The program floors for the NIR will be adjusted upward (downward) by the cumulative downward (upward) deviations in external debt service and downward (upward) by the cumulative downward (upward) deviations in nonproject external financial assistance relative to program assumptions. For purposes of calculating the adjusters, these flows will be valued at current exchange rates.

11. **Reporting requirements.** A table on the NIR prepared by the BCV will be transmitted on weekly basis, with a maximum delay of two weeks.

E. Nonaccumulation of New Domestic Payments Arrears

12. As part of the program, the government will not accumulate any new domestic payments arrears. This will be monitored through the monthly execution of the cash-flow plan and the corresponding release of budget appropriations. For programming purposes, a domestic payment obligation to suppliers is deemed to be in arrears if it has not been paid within the normal grace period of 60 days (30 days for government salaries and debt service) or such other period either specified by the budget law or contractually agreed with the

supplier after the verified delivery of the concerned goods and services, unless the amount or the timing of the payment is subject to good faith negotiations between the government and the creditor.

13. **Reporting requirements.** The Ministry of Finance and Economic Planning, through the D.G.T., will submit on a quarterly basis a detailed table of the stock of domestic payments arrears, including the accumulation, payment, rescheduling and write-off of domestic payments arrears during the quarter. The data are to be provided within four weeks after the end of the quarter.

F. Nonaccumulation of External Payments Arrears

14. As part of the program, the government will not accumulate any new external payments arrears on a continuous basis. This will be monitored through the monthly execution of the cash-flow plan and the corresponding release of budget appropriations.

15. External arrears are defined as total external debt-service obligations of the government that have not been paid by the time they are due, except where agreements between the government and creditors explicitly provide for a grace period after such obligations falling due. External arrears exclude arrears on external debt, pending the conclusion of debt-rescheduling agreements.

16. **Reporting requirements.** Data on (i) debt-service payments; and (ii) external arrears accumulation and payments will be transmitted on a quarterly basis by the Ministry of Finance and Economic Planning, within five weeks of the end of each quarter. In addition, the government will inform the Fund staff immediately of any accumulation of external arrears.

II. STRUCTURAL ASSESSMENT CRITERIA¹

A. Complete Implementation of the Automatic Utility Tariff Adjustment Mechanism

17. The implementation of the automatic utility tariff adjustment mechanism will be deemed complete when (i) the technical specifications, including the adjustment schedule and specification of cost changing events that will trigger an tariff adjustment, have been agreed upon between Electra and the autonomous economic regulatory authority (ARE); (ii) the details of the adjustment mechanism have been published; (iii) tariff levels are brought in line with the agreed mechanism; (iv) ARE's authorization of tariff adjustments reflects full and transparent application of the mechanism; and (v) ARE publishes its decisions on tariff adjustments without delay.

¹ See Table 2 of the memorandum of economic and financial policies.

III. OTHER DATA REQUIREMENTS FOR PROGRAM-MONITORING PURPOSES

18. Data on exports and imports, including volume and prices and compiled by the Director of Customs and the BCV, will be transmitted on a quarterly basis within five weeks after the end of each quarter. A preliminary quarterly balance of payments, compiled by the BCV, will be forwarded within five weeks after the end of each quarter.
19. The monthly disaggregated consumer price index for Cape Verde, compiled by the National Institute of Statistics (INE), will be transmitted monthly, within five weeks after the end of each month.
20. Documentation of all measures taken by the government to meet assessment criteria or indicative benchmarks under the program will be transmitted to the Fund staff within one week after the day of implementation