Democratic Republic of São Tomé and Príncipe and the IMF

Press Release:
IMF Executive Board Completes Sixth Review under PRGF Arrangement for São Tomé and Príncipe's and Approves US$680,000 Disbursement
June 19, 2008

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Democratic Republic of São Tomé and Príncipe: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

June 4, 2008

LETTER OF INTENT

São Tomé, June 4, 2008

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

1. The attached Memorandum of Economic and Financial Policies (MEFP) sets out the objectives and policies that the Government of the Democratic Republic of São Tomé and Príncipe intends to pursue for the remainder of 2008. They are consistent with the Government's Poverty Reduction Strategy (PRS) and the objectives of the three-year arrangement under the IMF's Poverty Reduction and Growth Facility (PRGF). Our economic adjustment and reform efforts are being supported by the international community, notably through debt relief under the Enhanced Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI).

2. The Government of the Democratic Republic of São Tomé and Príncipe has made progress in economic adjustment and structural reforms over the past year, amid a difficult external economic environment. Economic growth has remained robust. In response to rising international prices for food and fuel, the Government raised the domestic prices for petroleum products, electricity, and water in the second half of 2007 to reduce implicit subsidies. It also intensified efforts to mobilize aid and took steps to strengthen public financial management. However, annual inflation rebounded since mid-2007, reflecting the higher prices of our imports and depreciation of the dobra, especially against the euro, the main invoicing currency for imports. Our domestic primary fiscal deficit was higher than envisaged under the program owing mainly to higher energy prices.

3. To bring inflation to a downward path, we are determined to strengthen policy implementation, particularly in containing domestic primary expenditure and in curtailing liquidity growth. Our policies for the remainder of 2008 aim to consolidate financial stability, ensure sound management of oil-related and debt relief resources, and lay the groundwork for sustained private sector-led growth. Our program envisages a further reduction of the domestic primary fiscal deficit relative to GDP, a strengthening of monetary and exchange rate policies to lower inflation, and an acceleration of structural reforms. These are key conditions for sustained growth, which in turn is key for poverty reduction.

4. In support of our objectives and policies, the Government hereby requests the completion of the sixth review and the disbursement of the seventh loan under the PRGF

arrangement in an amount equivalent to SDR 0.423 million (5.7 percent of quota). The Government requests a waiver for the nonobservance of the end-December 2007 performance criteria on net bank credit to the Government and the domestic primary fiscal deficit, based on the corrective measures we are taking. The Government also requests a waiver for the nonobservance of the end-December 2007 structural performance criterion related to upgrading the computerized public financial management system. The intended policy steps were taken in early 2008.

5. The Government will provide the IMF with such information as the IMF may request regarding progress in implementing economic and financial policies and achieving the objectives of the program.

6. The Government believes that the policies and measures set forth in the MEFP are adequate to achieve the objectives of the 2008 program supported by the PRGF arrangement, but will take further measures to that end if deemed necessary. During the implementation of the arrangement, the Government will consult with the Managing Director of the IMF on the adoption of any measures that may be appropriate, at the initiative of the Government or whenever the Managing Director requests such a consultation.

7. The Government intends to make the contents of this Letter of Intent and those of the attached MEFP and Technical Memorandum of Understanding (TMU), as well as the IMF staff report on the sixth PRGF review, available to the public and authorizes the IMF to arrange for them to be posted on the IMF website, subsequent to Executive Board completion of the sixth review.

Yours truly,

s./

Mr. Raul António da Costa Cravid
Minister of Planning and Finance

s./

Mr. Luis Fernando Moreira de Sousa
Governor of the Central Bank of São Tomé and Príncipe

Attachments: Memorandum of Economic and Financial Policies
Technical Memorandum of Understanding

SÃO TOMÉ AND PRÍNCIPE: MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES
March 26, 2008

I. INTRODUCTION

1. This Memorandum of Economic and Financial Policies (MEFP) supplements that of October 20, 2007 and our Letter of Intent dated December 1, 2007. The new coalition Government, which took office in February 2008 with a majority in the National Assembly, is committed to the policies under the PRGF-supported program. This MEFP describes (i) performance under the PRGF arrangement through December 2007, (ii) economic developments in 2007 and early 2008, and (iii) the Government's economic program for the remainder of this year. The policies set forth in this Memorandum should help achieve the medium-term objectives set out in our PRSP, including efficient use of debt relief resources provided under the Enhanced Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI). Our Government is committed to creating the conditions for sustained economic growth, which is essential for reducing poverty.

II. RECENT ECONOMIC DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM

2. **Economic activity remained robust in 2007, with real GDP growth estimated at 6 percent**. Tourism-related construction, communication, and other services sectors continued to be the main drivers of output growth, boosted by foreign direct investment. Cocoa exports increased on the back of rising world market prices and higher export volume but the traditional agriculture sector remains depressed.

3. **Consumer price inflation rebounded to 27.6 percent (year-on-year) at the end of December 2007, after a significant decline in the first half of the year**. This acceleration reflected the impact of exogenous factors such as rising import prices for food and fuel and appreciation of the euro, the main invoicing currency for our imports.[1] It was also influenced by higher public expenditure and faster than programmed liquidity growth. In addition, the Government sharply raised domestic prices of petroleum products (by 14-25 percent) and electricity and water tariffs (by 40-60 percent) in September 2007, after increases in international oil prices, in order to reduce implicit subsidies. The dobra depreciated against the U.S. dollar and the euro by 10 and 26 percent, respectively, in 2007.

4. **Despite higher than projected domestic revenue, the domestic primary fiscal deficit exceeded the performance criterion for end-December 2007** (Table I.1). Domestic revenue recovered in the second half of the year, led by higher income tax receipts, as well as

[1] Food items account for 72 percent of the basket for the consumer price index. About 80 percent of food consumption in the country depends on imports. All oil products are imported.

tax arrear collections. However, the domestic revenue gains of about 1.2 percent of GDP vis-à-vis the program target were more than offset by a sharp rise in current spending, especially on utilities, transfers, and medical expenses. A significant part of the utility payments to EMAE, the state-owned electricity and water company, was to mitigate the impact of the sharp utility tariff hike on the population. Higher current spending also contributed to lower funding available for domestically financed capital expenditure. The widening domestic primary deficit, at 8.1 percent of GDP, was financed by a larger-than-projected drawdown of government deposits at the central bank (BCSTP), including from the National Oil Account (NOA). The Government also made efforts to mobilize external financing, which helped in clearing arrears on scholarships and other current outlays.

5. **Base money growth accelerated from 23 percent (year-on-year) in June 2007 to 50 percent by the end of the year**. While part of base money growth was due to strong foreign currency flows to the banking system, the excess increase in dobra liquidity reflected the fact that the BCSTP's sterilization of budgetary use of oil bonuses and donor grants fell short of what was needed to adequately bring down liquidity growth. As a result, base money grew much faster than programmed, while net international reserves exceeded the program target by a large margin.

6. **The exchange rate of the dobra remains market-determined**. The BCSTP has continued to adjust its exchange rate to market conditions daily by calculating it as the sum of 40 percent of the previous day's selling rate quoted by commercial banks and 60 percent of its own previous day's selling rate. The excess liquidity put pressure on the exchange rate and the spread between the reference exchange rate of the central bank and commercial banks exchange rate widened in the second half of 2007 to over 2 percent.

7. **Progress on structural reforms has been mixed**. The end-December 2007 structural performance criterion on public financial management system was met with delay—the intended policy steps were taken in early 2008 (Table I.2). On structural benchmarks, the 2008 budget was prepared and submitted to the National Assembly (NA) in mid-December 2007. It has since been withdrawn and needs to be resubmitted with an updated public investment program. In early 2008, the BCSTP issued the new regulations on capital adequacy, internal control and auditing, bank financial reporting, and credit to employees. The Oil Revenue Management Law (ORML) handbook was posted on the internet in December 2007. However, the direct taxation reform package (new corporate and personal income tax and urban property tax laws) has not yet been approved pending resubmission by the new Government of the draft income tax law. The NA has not yet given its final approval to the anti-money laundering (AML/CFT) law. The National Oil Agency has prepared a Petroleum Sector Strategy and a set of laws for launching licensing for the Exclusive Economic Zone (EEZ), but their adoption has been delayed.

8. **Implementation of public enterprise reform has been slow**. Under a reform strategy for EMAE, utility tariffs were increased to cover production costs. EMAE has also

introduced prepaid electricity meters to strengthen payment collection. Nevertheless, EMAE's facilities need repair and investment, its financial standing remains weak, and its operational efficiency is low. Similarly, ENASA, the airport authority, has difficulties in covering its operating costs, with large arrears on electricity. Overstaffing and other problems led to a bloated cost structure in ENAPPORT, the seaport authority.

III. Economic Policies for the Rest of 2008

9. **Against the backdrop of strong negative terms-of-trade shocks, the authorities attach high priority to restoring financial stability**. The Government and the central bank of São Tomé and Príncipe are determined to make a concerted effort to strengthen expenditure control and liquidity management prior to the Executive Board consideration of the sixth review.

10. **For the rest of 2008, our macroeconomic framework aims to maintain real GDP growth at 6 percent, reduce annual inflation to 13-15 percent by the end of the year, and safeguard international reserves equivalent to 4 months of imports**. We will make every effort to speed up structural reforms, which are critically important for addressing our economy's supply constraints, restoring fiscal sustainability over the medium term, and mobilizing support from the World Bank and other multilateral and bilateral development partners.

A. Fiscal Policy

11. **The Government plans to further reduce the domestic primary deficit to 5.2 percent of GDP in 2008, from 8.1 percent in 2007**. Fiscal consolidation in the 2008 budget would come mainly from the expenditure side, because the revenue impact of the envisaged direct tax reforms, which aim to reduce distortions, would be largely neutral in 2008. The domestic primary deficit is expected to be financed by the use of IDA Development Policy Operation (DPO) grant of US$4.5 million and a draw-down of up to US$3 million from the National Oil Account (NOA). There should be no recourse to domestic banking system credits (excluding the NOA).

12. **In the period immediately ahead, the Ministry of Planning and Finance will significantly tighten expenditure control to prevent the recurrence of an expenditure overrun**. Specifically,

- To put in place a functioning computerized public financial management system (SAFINHO), the Ministry of Planning and Finance will establish a Directorate of Accounting and an IT office by end-March 2007, in addition to procuring and installing IT equipment. We intend to make progress in training users of the upgraded SAFINHO at the level of spending entities in the following months.

- Strict (quarterly) limits will be set on nonessential current spending, particularly on goods and services and transfers not funded by donors.

- Withdrawals from the National Oil Account will be in strict compliance with the provisions of the ORML.

13. **Other expenditure measures planned for 2008 include**:

- **Containing budgetary personnel costs**. The full year impact of the 2007 general wage increase will be felt in 2008. The Government will closely monitor all components of the wage bill and strictly limit the payments of bonuses and benefits to ensure that the wage-bill-to-GDP ratio declines from 8.9 percent in 2007 to 8.6 percent in 2008.

- **Public wage reform**. As part of its civil service reform strategy to be supported by the World Bank under the DPO, the Government plans to integrate fringe benefits into the wage bill and adopt a revised salary structure, based on a comprehensive wage study, with incentives for public servants, as a first step in its strategy. These reforms are critically important for restoring fiscal sustainability and enhancing the growth orientation of the budget.

- **Adjusting nonwage current spending**. Transfers to the Joint Development Authority (JDA) will need to be reassessed, taking into account budget constraints, oil revenue prospects, and the execution of the JDA budget. Discretionary expenditures on goods, services, and other items will have to be restrained to correspond with available resources.

- **Assisting the most vulnerable segments of the population**. We plan to achieve this goal through better implementation of HIPC-related expenditure programs and a temporary, targeted scheme for the most vulnerable groups. The latter scheme, to be financed by part of the IDA DPO grant (US$0.5 million), will facilitate adjustment to higher import prices for food and fuel. While aligning allocations with the PRSP priorities set out in the Priority Action Plan for 2006–08, we will improve the monitoring of pro-poor spending.

- **Improving the execution of public investment projects**. Increasing infrastructure investment, especially in transportation and the electricity sector, will help address supply bottlenecks and enhance growth potential. We will work closely with our external development partners to accelerate implementation of foreign-funded projects, while ensuring adequate resources for domestically funded investment projects.

14. **On the revenue side, the Government will focus on the following measures**:

- **Timely adoption and implementation of the new direct taxation laws**. The Government has resubmitted the draft income tax law to the NA, aiming to obtain NA approval of the tax reform package by the end of April 2008. The package of legislation includes a reduction in the corporate tax rate from 45 to 25 percent, a move to a progressive personal income tax from the current flat rate of 13 percent, and application of the urban tax code. Timely implementation after NA approval would help broaden the tax base, reduce distortions, and increase revenue buoyancy.

- **Strengthened tax and customs administration**. With support from the US Millennium Challenge Corporation (MCC), the tax authorities will step up efforts to audit tax returns, keep track of large tax payers, and compile and collect tax arrears, particularly from large tax payers. To facilitate tax arrear collections, the Government intends to set up tribunals to settle tax disputes.

15. **To strengthen the monitoring and execution of the 2008 budget, the Government will further improve the public financial management system**. With assistance from multilateral and bilateral donors, efforts will be made to put in place new modules to implement the public accounting system, prepare regulations for the organic budget law (SAFE law), and develop SAFINHO into a fully fledged eSAFE system incorporating all public accounts, including patrimony and debt.

16. **Prudent use of donor budgetary support and the remaining oil bonuses is essential for maintaining macroeconomic stability in the next several years**. Total grants from IDA under the DPO are expected at US$6 million. As no additional DPO grants are envisaged in the next few years, the Government intends to save part of the grant (US$1.5 million) for future use. In view of the rapidly declining NOA balance, high uncertainty regarding additional oil signature bonuses in 2008, and further delays in oil exploration drilling in Blocks 2 and 4, annual draw-down of the NOA will be strictly limited. The Government is committed to adjusting the medium-term fiscal and financing strategies, including the use of NOA resources if oil production and exports are seriously delayed beyond the previous projection of 2014.

B. Monetary and Exchange Rate Policies

17. **We recognize that to return inflation to a downward path, the BCSTP must step up its effort to mop up excessive liquidity and significantly bring dobra base money growth down.** Weak financial intermediation and high currency substitution in our economy severely limit the effectiveness of interest rates and other monetary policy instruments. We therefore have to rely on fiscal restraint and foreign exchange sales to control liquidity. The BCSTP will use foreign exchange auctions more actively, consistent with the program's NIR target, aiming to lower the 12-month growth rate of dobra base money from 50 percent in December 2007 to 35 percent by the end of March 2008 and 25 percent by the end of June 2008. Our monetary program for the rest of 2008 aims to keep base money growth on a declining trend, in order to achieve the program's objective of reducing inflation.

18. **The BCSTP and the Treasury Department of the Ministry of Planning and Finance intend to strengthen their cooperation to ensure that the BCSTP takes timely action to sterilize budgetary use of oil bonuses, donor funds, and HIPC and MDRI savings**. Regular information-sharing among the Ministry of Planning and Finance and BCSTP officials will include the Treasury's cash outlays (in both domestic and foreign currency), which are important for the BCSTP's liquidity forecast and foreign exchange market operations. To help liquidity forecast, the BCSTP will use the weekly average, rather than the monthly average, in measuring commercial banks' compliance with the minimum reserve requirements. Because public expenditure is a major component of aggregate demand that also affects domestic prices and the exchange rate, if meeting the program's NIR target is at risk, the Government will support monetary tightening by curtailing domestic primary expenditures.

19. **The BCSTP is committed to deepening foreign exchange market reform**. While accepting the obligations under Article VIII, Sections 2(a), 3, and 4, of the IMF's Articles of Agreement remains our goal, in the near term, the Government will focus on expediting approval by the National Assembly of the new investment code, which contains provisions aiming to remove the exchange restriction on transferring dividends abroad. To remove the remaining multiple currency practices, the BCSTP will consider revising the mechanism for setting the daily official exchange rate, based on a careful review of domestic market conditions. The revised mechanism would ensure that the spread between the official and commercial bank exchange rates will not exceed 2 percent. The BCSTP will continue implementing the current policies of holding regular foreign exchange auctions and progressively expanding the foreign exchange auction market to ensure a fuller and faster market determination of the exchange rate.

20. **The BCSTP will continue with its communication strategy of informing the market of its monetary and exchange policies.** In addition to the BCSTP regular meetings with the banking community and the media, data on monetary and macroeconomic aggregates will be posted daily on the central bank's website. The BCSTP will also post yearly audited financial statements. Its budget execution and profit and loss accounts on a cash basis will be reported at least quarterly, as part of the program's monetary data.

C. Structural Reforms

21. **Reducing the cost of investing and doing business in São Tomé and Príncipe is crucial for developing our economy's productive and export potential**. The Government intends to press ahead with the following reforms: (i) with external technical assistance, complete the revision of the commercial codes; (ii) enact and implement the new investment code and the revised labor code. The investment code would provide equal treatment to foreign and domestic investors. Revisions to the labor code would aim to more clearly define hiring and firing rules, remove ambiguities in contractual employment arrangements, and increase labor market flexibility by eliminating regulatory impediments; and (iii) submit and

obtain NA approval of the draft legislation, prepared in consultation with the private sector, to reduce red tape and other regulatory impediments to start a business.

22. **We will build on our recent progress to further enhance transparency and accountability in managing current and prospective oil resources**. The Minister of Natural Resources and Environment issued an order in August 2007 verifying São Tomé and Príncipe's formal adherence to the Extractive Industries Transparency Initiative (EITI). A national coordinator for implementation of the EITI has also been appointed. More recently, the International Board of the EITI has accepted São Tomé and Príncipe as a Candidate State of the Initiative, in recognition of our serious commitment to transparently manage oil revenues. To make further progress, we will adopt the Petroleum Sector Strategy and submit to the NA the legal framework for the EEZ including the Framework Law On Oil-Related Activities, the Taxation Law, and the Production-Sharing Contract Model. The National Oil Agency will strive to conduct the licensing round for the EEZ transparently and consistent with the ORML and the EITI.

23. **Regarding financial sector reform, our top priority is to obtain NA final approval of the AML/CFT law**. We are aware that the country would be negatively affected if we do not catch up in this important area. We therefore will work closely with the NA to expedite the legislative process. Once the NA gives final approval to the AML/CFT law, the implementation regulations, which the BCSTP has already prepared, will be issued. In addition, based on a review which has already been undertaken, the BCSTP intends to strengthen the requirements for issuing bank licenses, including by raising the minimum capital requirement. To reduce the risk of bank distress arising from non-performing loans, the BCSTP, with IMF technical assistance, will further strengthen its capacity to enforce banking supervision regulations through training, implementing the new chart of accounts and quarterly financial reporting by banks, and setting up a central credit unit to facilitate credit information sharing among banks.

24. **Pressing ahead with reforms in key sectors, such as agriculture, transportation, and energy, is of fundamental importance if living standards are to improve on a sustainable basis**. We will continue working closely with the World Bank and other development partners to promote agricultural marketing, commercial fishing, and tourism-related services. We will also address EMAE's financial and technical weaknesses through tariff and other reforms, increase the productivity of ENAPORT through outsourcing (e.g. cleaning, security guards), and attract investment to upgrade our infrastructure, including the airport runway and seaport.

D. Debt Management

25. **The Government is fully aware of the importance of ensuring debt sustainability after HIPC and MDRI debt relief**. We will refrain from new external borrowing, particularly on commercial terms, and redouble our efforts to seek full delivery of HIPC debt

relief from the remaining official creditors. We have initiated discussions on debt cancellation with Angola and Portugal and will try to conclude these agreements as soon as possible. The Government will further improve debt management by utilizing the Commonwealth Secretariat debt management system (CS-DRMS).

E. Capacity Building

26. **São Tomé and Príncipe continues to need international support to build capacity for policy monitoring and implementation**. The World Bank is providing support for our public financial management reform. A resident macroeconomic advisor, supported by Portugal, is now working in the Ministry of Planning and Finance. Under the US MCC's Threshold program, technical advisors are assisting our tax and customs administration and providing advice to help improve the business environment. We have benefited from IMF technical assistance in central banking, public finances, and statistics and will strive to use such assistance more effectively in the future. We welcome a mission from the IMF's Monetary and Capital Market Department to assess our technical assistance needs and a mission from the Finance Department to conduct a safeguard assessment after the current PRGF arrangement expires in August 2008.

27. **We will further improve our economic statistics**. Within our very tight budget constraints, we will provide support for a new household expenditure survey in order to improve compilation of the consumer price index. Further progress will also be made to improve budget classification and the consistency between monetary and fiscal data.

F. Program Monitoring

28. **To facilitate expenditure control and liquidity management, indicative targets for selected fiscal and monetary variables are set for end-March and end-June 2008** (Table I.1). These include indicative ceilings for primary nonwage current spending, 12-month dobra base money growth, and net international reserves of the BCSTP. The non-accumulation of external payment arrears (as defined in the attached Technical Memorandum of Understanding) is a continuous performance criterion, as are the injunctions against imposing or intensifying restrictions on current payments, introducing new or modifying existing multiple currency practices, concluding bilateral payments agreements that are inconsistent with Article VIII of the Fund's Articles of Agreement, or imposing new or intensifying existing import restrictions for balance of payments purposes. Two structural benchmarks are added, one on the adoption of the 2008 budget, in line with the PRGF-supported program, and another on approval of the direct taxation reform package for end-April 2008 (see Table I.2).

29. **The attached Technical Memorandum of Understanding sets out the modalities of program monitoring.** These include definitions of performance criteria and indicative targets; application of adjustors for deviations from programmed amounts of oil signature

bonuses, budget support, and net external debt service payments; and data sources and frequency of data reporting.

30. **We have recently provided the second Annual Progress Report on the PRSP to the Fund and the World Bank**. We welcome the positive assessment of the staff of the two institutions conveyed by the mission and look forward to the Joint Staff Advisory Note. Looking forward, we will enhance monitoring and evaluation to ensure effective and successful implementation of the PRSP and update the PRSP when new information on oil prospects, especially after further oil exploration drilling in the JDZ, becomes available.

Table I.1. São Tomé and Príncipe: Performance Criteria and Indicative Targets

(Billions of dobras, cumulative from September 2006, unless otherwise specified)

	2006		2007					2008	
	Sep. 30		Jun. 30		Dec. 31			Mar. 31	Jun. 30
	Base (stocks)	Base (stocks, excl. NOA)	Perf. Criteria CR/07/102	Actual	Perf. Criteria CR/07/267	Perf. Criteria CR/07/267 (with adjustors)	Actual	Ind.Target	Ind.Target
1. Floor on domestic primary balance (as defined in the TMU; cumulative from beginning of year)	...	...	-97.0	-97.0	-137.3	-137.3	-158.4	-22.6	-80.0
2. Ceiling on changes in net bank financing of the government (cumulative from end–September 2006; billions of dobras at program exchange rate) [1,2,3]	-126.8	-20.8	-32.4	-60.7	-33.8	-83.2	-30.9	70.8	-21.7
3. Ceiling on changes in net domestic assets of the central bank (cumulative from end–September 2006; billions of dobras at program exchange rate) [1,2,3]	-289.8	-183.8	-19.6	-86.5	26.3	-23.1	-65.0	52.3	-8.4
4. Floor on changes in the net international reserves of the central bank (cumulative from end–September 2006; US$ millions) [3,4]	41.8	33.4	1.9	4.9	1.0	4.5	10.1	-2.1	2.7
5. Ceiling on central government's outstanding external payment arrears (stock, US$ millions) [5]	...	...	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6. Ceiling on the contracting or guaranteeing of new nonconcessional external debt with original maturity of more than one year by the central government or the BCSTP (cumulative flows from January 2005, € millions) [6,7]	...	...	1.6	0.0	1.6	1.6	1.6	1.6	1.6
7. Ceiling on the outstanding stock of external debt with original maturity of up to and including one year owed or guaranteed by the central government or the BCSTP (stock, US$ millions) [8]	...	...	1.0	0.0	1.0	1.0	1.0	1.0	1.0
Memorandum items:									
Base money (ceiling; billions of dobras) [9]	273.2	...	302.5	318.2	337.0	...	417.1	391.6	389.2
Currency Issued (ceiling; billions of dobras)	94.4	...	105.0	88.7	124.5	...	126.2	135.2	122.0
Oil signature bonuses including accrued interest on NOA (US$ millions, cumulative from beginning of year)	0.5	...	28.8	16.0	29.0	...	30.9	0.2	26.5
Transfer from NOA to the budget (US$ millions, cumulative from beginning of year)	...	...	8.0	8.0	8.0	...	10.3	0.0	3.0
Net external debt service payments (cumulative from beginning of the year, billions of dobras at program exchange rate) [10]	-35.4	...	-211.0	-213.2	-220.0	...	-229.4	-4.2	-8.5
Official external program support (cumulative from beginning of the year, billions of dobras at program exchange rate) [11]	7.8	...	0.0	0.0	41.8	...	62.7	12.3	81.3

Sources: São Tomé and Príncipe authorities; and IMF staff estimates and projections.

[1] For 2007 and 2008, the ceiling will be adjusted downward or upward according to definitions in the TMU.
[2] The ceiling will be adjusted downward by the amount of accumulated domestic arrears.
[3] The National Oil Account (NOA) at the Central Bank is included in 2007 and excluded in 2008.
[4] For 2007 and 2008, the floor on net international reserves will be adjusted upward or downward according to defnitions in the TMU.
[5] This is a continuous performance criterion.
[6] This performance criterion applies not only to debt as defined in point No. 9 of the *Guidelines on Performance Criteria with Respect to Foreign Debt* (August 24, 2000), but also to commitments contracted or guaranteed for which value has not been received.
[7] With a grant element of less than 50 percent.
[8] Debt is defined as in point 9 of the *Guidelines on Performance Criteria with Respect to Foreign Debt* (August 24), 2000.
[9] BCSTP targets the dobra component of base money, rather than total base money, since the latter includes a large, volatile foreign currency component.
[10] Includes US$15 million repayment to Nigeria in 2007.
[11] Official external program support, as defined in the TMU, valued at the program exchange rate of 12,549 dobras per U.S. dollar (valued at projected average exchange rate of 13,935 dobras per U.S. dollar in fiscal

Table I-2. São Tomé and Príncipe: Structural Performance Criteria and Benchmarks June 2007–December 2008

Action	Performance Criteria / Benchmark	Status
June 2007		
• Issue new prudential regulations on credit classification, liquidity, transactions with related parties, and limits on bank net open foreign currency positions.	Performance Criteria	Three regulations (credit classification, liquidity, and transactions with related parties) were issued in August; the regulation on net open foreign currency positions was issued in November 2007.
• Produce the monthly budget execution report (TOFE) using upgraded SAFINHO.	Benchmark	Reports are prepared monthly.
• Finalize the installation of 3,000 prepaid electricity metering systems.	Benchmark	About 1,000 meters installed by September 2007.
September 2007		
• Prepare the 2008 budget in line with the new organic budget law (SAFE) for submission to the National Assembly.	Benchmark	The 2008 budget is in line with the new SAFE and was submitted to the NA on December 12, 2007.
December 2007		
• Make progress toward the fully integrated computerized public financial management system (eSAFE) by: (i) the issuance of an administrative decree by the Minister of Finance to establish the IT office; and (ii) the issuance of tenders for the procurement of IT equipment for upgrading SAFINHO.	Performance Criteria	In early 2008, the administrative decree to establish the IT office and the Directorate of Accounting were approved by the Council of Ministers and the tender for the procurement of IT equipment was issued.
• Adopt Petroleum Sector Strategy to develop the Exclusive Exploration Zone (EEZ).	Benchmark	Petroleum Sector Strategy prepared by the National Petroleum Agency, pending approval by the Council of Ministers.
• Issue new regulations on capital adequacy, internal control and auditing, bank financial reporting, and credit to employees.	Benchmark	All new regulations issued in the early 2008.
March 2008		
• Establish a Directorate of Accounting and an IT office. Install IT equipment.	Benchmark	Bill passed to establish offices but due to delays in donor funding, the offices are not yet established and the IT equipment not yet purchased.
• Revise the commercial codes, with external technical assistance, in order to reduce the cost and time of doing business.	Benchmark	External technical still ongoing.
• Adopt the new income tax code, corporate tax code, and urban property tax code.	Benchmark for April 2008	Expected in late June.
• Adopt the 2008 budget in line with the PRGF-supported program.	Benchmark for April 2008	Adopted on May 7, 2008 in line with the program.
June 2008		
• Revise the mechanism for setting the daily official exchange rate to keep the spread between the official and commercial banks exchange rates within the permissible range.		
• Prepare regulations under the SAFE law.		
• Put in place new modules to implement the public accounting system and train users.		
• Initiate preparation of an action plan to compile the payment arrears of EMAE and ENAPORT.		

TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This technical memorandum of understanding (TMU) contains definitions and adjuster mechanisms that are intended to clarify the measurement of variables in Table 1, Quantitative Performance Criteria, PRGF Arrangement, 2006–07, which is attached to the Memorandum of Economic and Financial Policies. Unless otherwise specified, all quantitative performance criteria and benchmarks will be evaluated in terms of cumulative flows from end-September 2006.

I. Provision of Data to the Fund

2. Data with respect to all variables subject to performance criteria and indicative targets will be provided to Fund staff monthly with a lag of no more than four weeks for data on the net domestic assets and net international reserves of the Central Bank of São Tomé and Príncipe (BCSTP) and eight weeks for other data. The authorities will transmit promptly to Fund staff any data revisions. For variables that are relevant for assessing performance against program objectives but are not specifically defined in this memorandum, the authorities will consult with Fund staff as needed on the appropriate way of measuring and reporting. Performance criteria included in the program, as defined below, refer to domestic primary balance of the central government, net bank financing of the central government, net domestic assets and net international reserves of the central bank, external payments arrears, nonconcessional medium and long-term external debt, and short-term external debt.

II. Definitions

3. **Government** is defined for the purposes of this TMU to comprise the central government, which includes all governmental departments, offices, establishments, and other bodies that are agencies or instruments of the central authority of São Tomé and Príncipe. The central government does not include the operations of state-owned enterprises.

4. **Government domestic revenue (excluding oil revenue)** comprises all tax and nontax revenue of the government (in domestic and foreign currency), excluding foreign grants, the receipts from the local sale of in-kind grants (e.g., crude oil received from Nigeria, food aid, etc.), and any gross inflows to government on account of oil signature bonus receipts and accrued interest in the National Oil Account (NOA). Revenue will be measured on a cash basis as reported in the table of government financial operations prepared by the Directorate of Budget and the Directorate of Treasury in the Ministry of Planning and Finance.

5. **Domestic primary expenditure** comprises all government spending assessed on a commitment basis (base *compromisso*), excluding (i) foreign-financed capital expenditure; (ii) foreign-financed expenditure under the overseas scholarship program that is externally financed; and (iii) scheduled interest payments. Reporting of government domestic expenditure will be based on the state budget execution prepared every month by the

Directorate of Budget and the Directorate of Treasury in the Ministry of Planning and Finance.

6. Within domestic primary expenditure, **propoor expenditure** refers to government outlays recorded in the budget nomenclature that have a direct effect on reducing poverty, as agreed with the IMF and World Bank staffs. These expenditures, which include both current and capital outlays, are defined as follows:

a. **Propoor current spending**: These cover the following ministries and expenditure categories (by budget code) as described in the matrix below:

Code	Description of expenditure	Ministry of Education	Ministry of Health	Ministry of Labour
01.00.00	Despesa com Pessoal	x	x	x
02.01.05	Outros bens duradouros	x	x	
02.02.02	Combustiveis e lubrificantes	x	x	x
02.02.04	Alimentacao	x		
02.02.05	Medicamentos	x	x	
02.02.06	Roupas e clasados	x	x	x
02.02.09	Outros bens nao duradouros	x	x	
02.03.01.01	Agua e energia	x	x	x
02.03.02	Conservacao de bens	x	x	
02.03.06	Comunicacoes	x	x	x
04.02.01	Instituicoes particulares	x		x
04.03.01	Particulares (Junta de Saude)	x		x
04.04.02	Outras transferencias para exterior		x	
06.01.00	Ensino e formacao		x	
06.04.01	Custos recorrentes de projectos	x		
06.04.04.02	Outros Diversos	x	x	

Expenditures on fuels and lubricants (*combustíveis e lubrificantes*) that are effected for administrative purposes are excluded. Likewise, food (*alimentação*) and clothing and shoes (*roupas e calçados*) supplied to administrative staff are excluded.

For 2007 onward, the definition of propoor current spending, defined in the matrix above, will be based on the new budget nomenclature.

b. **Propoor capital spending:** This covers projects that are deemed to have a direct impact on alleviating poverty in the following sectors: education, health, social safety nets, agriculture and fisheries, rural development, planning and finance, youth and sports, provision of potable water, and electrification.

7. The **domestic primary balance** is defined as the difference between government domestic revenue and domestic primary expenditure. This balance for end-September 2006 was assessed at DB –109.6 billion, broken down as follows:

Government domestic revenue:	Db 217.3 billion
Less: Government primary expenditure (as defined in paragraph 5)	Db 326.9 billion
Equals: Domestic primary balance:	Db –109.6 billion

8. **Domestic arrears** are defined as the difference between expenditure on a commitment basis and cash payments (amounts past due and unpaid).

9. **The program exchange rate** for the purposes of this TMU will be Db 12,548.5 per U.S. dollar. The exchange rate of the dobra against the euro will be 15,952.93 and against the SDR will be 18,526.31.

10. **Net bank financing of the central government (NCG)** is defined as the stock of all outstanding claims on the government held by the BCSTP, less all deposits held by the central government with the BCSTP, plus the stock of all outstanding claims on the government held by deposit money banks (DMBs),[2] less all deposits held by the central government with DMBs as they are reported monthly by the BCSTP to the IMF staff. The National Oil Account (NOA) at the BCSTP is included in 2007 and excluded in 2008. All foreign exchange–denominated accounts will be converted to dobras at the program exchange rate. At end-September 2006, outstanding net bank financing of the government was assessed at Db –126.8 billion, broken down as follows:

BCSTP credit, including use of IMF resources:		Db 105.8 billion
Less: Government deposits with BCSTP:		Db 226.3 billion
Of which:	National Oil Account (NOA)	Db 106.0 billion
	Treasury foreign currency–denominated accounts	Db 43.9 billion
	Treasury local currency–denominated accounts	Db 28.7 billion
	Account for HIPC relief[3]	Db 20.3 billion
	Account for MDRI relief[4]	Db 0.0 billion
	Counterpart deposits	Db 22.6 billion
	PRGF disbursement account	Db 4.7 billion
Equals: Net credit to government by the BCSTP:		Db –120.5 billion

[2] Deposit money banks (DMBs) refer to other depository corporations, as defined in the *Monetary and Financial Statistics Manual.*

[3] Pending the use of HIPC debt relief for propoor spending.

[4] Pending the use of MDRI relief for propoor spending.

Plus:	DMBs credit:	Db 0.0 billion
Less:	Government deposits with DMBs (including counterpart funds):	Db 6.3 billion
Equals:	Net bank financing of the government:	Db 126.8 billion

11. **Base money** is defined as the sum of currency issued—which consists of currency outside banks and cash in vaults—and bank reserves, at the program exchange rate. Bank reserves refer to reserves of commercial banks held with the central bank and include reserves in excess of the reserve requirements. At end-September 2006 base money was assessed at dobras 273.2 billion, calculated as follows:

Currency issued:			Db 94.4 billion
Of which:	Cash in vaults:		Db 13.7 billion
	Currency outside banks:		Db 80.7 billion
Plus:	Bank reserves:		Db 178.7 billion
	Of which:	In dobras	Db 80.5 billion
		In foreign currency	Db 98.2 billion
Equals:	Base money:		Db 273.2 billion
	Of which:	In dobras	Db 175.0 billion

12. **Net international reserves** (NIR) of the BCSTP are defined for program-monitoring purposes as short term-term foreign assets of the BCSTP minus short-term external liabilities. All short-term foreign assets that are not fully convertible external assets readily available to and controlled by the BCSTP (i.e., they are pledged or otherwise encumbered external assets, including but not limited to the HIPC umbrella SDR account and assets used as collateral or guarantees for third-party liabilities) will be excluded from the definition of NIR. The NOA at the BCSTP is included in 2007 and excluded in 2008. All values are to be converted to U.S. dollars at actual market exchange rates prevailing at the test date. At end-September 2006 NIR was assessed at Db 524.6 billion, calculated as follows:

Net international reserves:			Db 524.6 billion
Of which:	Gross reserves:		Db 552.3 billion
	Of which: NOA		Db 106.0 billion
		Short-term liabilities:	Db –27.6 billion
Plus:	Other foreign assets:		Db 91.9 billion
Plus:	Medium and long-term liabilities:		Db –53.6 billion
Equals:	Net foreign assets:		Db 563.0 billion

Memorandum items:

Net international reserves minus NOA minus bank foreign currency deposits with the central bank	Db 320.4 billion

13. **Net domestic assets** of the central bank of São Tomé and Príncipe are defined as the difference between base money and net foreign assets of the BCSTP, all at programmed exchange rates. The NOA at the BCSTP is included in 2007 and excluded in 2008. All foreign-denominated accounts will be converted to dobras at the program exchange rate. At end-September 2006, net domestic assets were assessed at dobras –289.8 billion, calculated as follows:

Base money:		Db 273.2 billion
Less:	Net foreign assets:	Db 563.0 billion
Equals:	Net domestic assets of the BCSTP:	Db –289.8 billion

14. **Treasury deficit** of the BCSTP is defined as revenue (excluding unrealized valuation changes) minus costs minus investment.

15. The performance criterion on **short-term external debt** refers to the outstanding stock of external debt with an original maturity of one year or less (including overdraft positions) and owed or guaranteed by the government or the BCSTP.[5] At end-September 2006 the stock of short-term external debt stood at US$16.0 million.[6]

16. The performance criterion on **nonconcessional medium- and long-term external debt** refers to the contracting or guaranteeing of external debt with original maturity of more than one year by the government or the BCSTP.[7] [8] Debt rescheduling and restructuring are excluded from the ceilings set on nonconcessional borrowing. Medium- and long-term debt will be reported by the Debt Management Unit of the Ministry of Finance and Planning and (as appropriate) by the BCSTP, measured in US dollars at current exchange rates. The government will consult with IMF staff before contracting obligations if it is uncertain as to whether those obligations are within the performance criterion limits.

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[5] The term "debt" is defined in accordance with point 9 of the *Guidelines on Performance Criteria with Respect to Foreign Debt* (Decision No. 12274-(00/85) August 24, 2000).

[6] This amount includes three nonconcessional loans from Nigeria totaling US$15 million that were previously classified under nonconcessional medium-term external debt. They were reclassified as short-term debt after a joint World Bank-IMF debt sustainability analysis mission in April 2006.

[7] This performance criterion applies not only to debt as defined in point 9 of the *Guidelines on Performance Criteria with Respect to Foreign Debt* adopted on August 24, 2000, but also to commitments contracted or guaranteed for which value has not been received.

[8] The concessionality of loans is assessed according to the reference interest rate by currency published by the Development Assistance Committee of the Organization for Economic Cooperation and Development. For loans of terms of no less than 15 years, the 10-year average of commercial interest reference rates for the currency in which the loan is denominated will be used. For loans of shorter terms, the six-month average will apply. A loan is deemed to be on concessional terms if, on the date of initial disbursement, the ratio of the present value of the loan, calculated on the basis of the reference interest rate, to the nominal value of the loan is less than 50 percent (in other words, a grant element of at least 50 percent). For currencies with no available reference interest rates, the SDR rate will be used. This performance criterion does not apply to Fund resources.

17. The non-accumulation of new **external payment arrears** is a continuous performance criterion. Government external payment arrears are defined as all unpaid external public debt obligations, according to the data established by the Debt Management Unit of the Ministry of Planning and Finance and (as appropriate) by the BCSTP, except for arrears pending rescheduling arrangements. The latter will be considered technical arrears. Debt would be deemed to be in arrears when it has not been paid by the time it is due, unless arrears have been otherwise contractually defined. The performance criterion relating to external arrears does not apply to those pending the signing of bilateral agreements in the context of debt-rescheduling with the Paris Club and other bilateral creditors.

18. **Net external debt service payments** are defined as debt service due less interim HIPC debt relief (including multilateral and bilateral relief) and the accumulation of any new external payment arrears, including technical arrears.

19. **Official external program support** is defined as grants and loans, including in-kind aid when the products are sold by the government and receipts are freely usable by the budget, and other exceptional financing provided by foreign official entities and incorporated into the budget. Amounts assumed in the program consistent with this definition are shown in the memorandum item entitled "official external program support" of Table 1.

III. Use of Adjusters

20. **Deviations in receipts of oil signature bonuses, including accrued interest on NOA, in official external program support, and in net external debt service payments,** from amounts projected for the program (see Table I.1) will trigger adjustments for net bank financing of the central government, net domestic assets of the BCSTP, and net international reserves, as indicated below. These deviations will be calculated cumulatively from end-September 2006 (see Table 1).

21. **Ceilings on net bank financing (NCG) of the central government and net domestic assets (NDA) of the BCSTP:** Monthly differences between actual and projected receipts of oil signature bonuses, official external program support, and net external debt service payments in foreign exchange will be converted to dobras at the program exchange rate and aggregated from end-September 2006 to the test date. The ceilings will be adjusted downward by the amount of accumulated domestic arrears. For 2007 the ceilings on NCG and NDA will be adjusted downward or upward by cumulative deviations in the same direction of actual from projected net payments in external debt service, and by deviations in the opposite direction in external program support and oil bonuses, including accrued interest on the NOA. The downward adjustment of higher than programmed external program support will not take place to the extent that the additional support is used to accommodate higher capital outlays of the government, up to US$1 million. For 2008, the ceilings will be adjusted downward or upward by cumulative deviations in the same direction of actual from projected net payments in external debt service, and by deviations in the opposite direction in

external program support and transfers from the NOA to the budget that exceed US$3 million. The downward adjustment of higher than programmed external program support will not take place to the extent that the additional support is used to accommodate higher capital outlays of the government, up to US$1 million.

22. **Floor on net international reserves (NIR) of the BCSTP:** The quarterly difference between actual and projected receipts of oil signature bonuses, including accrued interest on NOA; official external program support; and net external debt service payments will be converted to dobras at the program exchange rate and aggregated from end-September 2006 to the test date. For 2007, the floor on NIR will be adjusted upward or downward by the cumulative deviation in the opposite direction in external debt service (including repayments to Nigeria), and by deviations in the same direction for oil bonuses, including accrued interest on NOA. The upward adjustment of higher than programmed external program support will not take place to the extent that the additional support is used to accommodate higher capital outlays of the government, up to US$1 million. For 2008, the floor on NIR will be adjusted upward or downward by the cumulative deviation in the opposite direction in external debt service, and by deviations in the same direction for transfers from the NOA to the budget that exceed US$3 million. The upward adjustment of higher than programmed external program support will not take place to the extent that the additional support is used to accommodate higher capital outlays of the government, up to US$1 million. In addition, the NIR floor will be lowered by the amount that disbursements under the PRGF arrangement are lower than expected.

IV. Data Reporting

23. The following information will be provided to the IMF staff for the purpose of monitoring the program.

i. Fiscal Data

The Directorate of Budget at the Ministry of Planning and Finance will provide to IMF staff, within two months after the end of each month or quarter, except for the public investment program (PIP), which will be provided three months after each quarter:

- Monthly data on central government operations for revenues, expenditure, and financing, including detailed description of net earmarked resources (*recursos consignados*)
- Monthly data on net credit to the government by the BCSTP, recorded account by account in a format fully compatible with the monetary accounts of the BCSTP
- Monthly detailed data on tax and nontax revenues
- Monthly detailed data on current and domestically financed capital expenditure on commitment (compromisso) and cash payments (caixa)

- Monthly data on domestic arrears by type
- Quarterly data on official external program support (non-project)
- Quarterly data on the execution of the public investment program (PIP) by project and sources of financing
- Quarterly data on project grant and loan disbursement (HIPC and non-HIPC)
- Quarterly data on bilateral HIPC debt relief
- Quarterly data on project loan disbursements
- Latest outstanding petroleum price structures and submission of new pricing structures (within a week of any changes)

ii. Monetary Data

The BCSTP will provide to IMF staff, within three weeks from the end of each month, the monetary accounts of the BCSTP; other monetary data will be provided within six weeks after the end of each month for monthly data, within two months after the end of each quarter for quarterly data, and within two months after the end of each year for annual data. Daily data will be provided every week no later than the Wednesday following the end of the week, and weekly data will be provided no later than two weeks after the end of the week. The BCSTP will provide:

- Daily data on exchange rates, to be posted on the central bank's web site.
- Daily data on interest rates, to be posted on the central bank's web site.
- Daily liquidity management table, including base money and currency in circulation (see attachment), to be posted on the central bank's web site.
- Weekly net international reserve position, to be posted on the central bank's web site
- Weekly balance sheet data of BCSTP (in BCSTP and IMF formats)
- Monthly balance sheet data of BCSTP (in BCSTP and IMF formats)
- Monthly balance sheet data of individual deposit money banks (in BCSTP and IMF formats)
- Monthly consolidated balance sheet data of deposit money banks (in BCSTP and IMF formats)
- Monthly monetary survey (in BCSTP and IMF formats)
- Monthly central bank foreign exchange balance (Orçamento cambial)
- Quarterly table on bank prudential ratios and financial soundness indicators
- Quarterly data on the BCSTP's financial position (profit and loss statement, treasury deficit, budget execution)

iii. External Debt Data

The Debt Management Unit at the Ministry of Planning and Finance will provide to IMF staff, within two months after the end of each month,

- Monthly data on amortization and interest on external debt by creditor: scheduled, subject to debt relief or rescheduling, and paid
- Quarterly data on disbursements for foreign-financed projects and program support loans

iv. National Accounts and Trade Statistics

The following data will be provided to IMF staff:

- Monthly consumer price index data, provided by the National Institute of Statistics within one month after the end of each month
- Monthly data on imports (value and import taxes collected and arrears) and commodity export values, provided by Customs within two months after the end of each month
- Monthly data on petroleum shipments and consumption (volumes and cif prices, by product), provided by Customs.