**International Monetary Fund**

Guinea-Bissau and the IMF

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# **Guinea-Bissau:** Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

March 11, 2010

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

## LETTER OF INTENT

Bissau, March 11, 2010

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

Dear Mr. Strauss-Kahn,

1. Guinea-Bissau made progress in stabilizing its economy in 2008–09 under the Fund's Emergency Post-Conflict Assistance (EPCA) program. The government is committed to building on this effort and pursuing a medium-term economic program aimed at achieving fiscal and external sustainability, reviving economic growth, and making progress toward poverty alleviation and the Millennium Development Goals (MDGs). We hope this will help catalyze stronger donor support and allow the country to move to the HIPC/MDRI completion point.

2. As envisaged in the attached Memorandum of Economic and Financial Policies (MEFP), the government medium-term economic program aims to strengthen public finances and implement structural reforms in the fiscal and other areas critical for growth and poverty reduction. To support our policies described in the MEFP, including assistance with our related balance of payment needs, the government of Guinea-Bissau requests assistance from the IMF under an Extended Credit Facility (ECF) arrangement in the amount of SDR 22.365 million (157.5 percent of quota), to be disbursed in three years. The government requests the disbursement of SDR 7.881 million upon approval of the arrangement, part of which will allow the early repurchase of Guinea-Bissau's outstanding EPCA credits of SDR 5.325 million. The government also requests the second tranche of interim HIPC assistance in the amount of SDR 1.016 million to cover PRGF repayment obligations falling due in 2010.

3. The government firmly believes that the policies elaborated in the attached MEFP are adequate to achieve the objectives of the ECF-supported program. However, if necessary it will swiftly adopt additional measures to meet these objectives. The government will consult with the Fund before adopting such measures or if there are changes in the policies contained in the MEFP, in accordance with the Fund's policies on such consultations.

The government authorizes the Fund to publish this letter of intent, the attached MEFP and Technical Memorandum of Understanding, and the staff report and DSA relating to this request.

Sincerely yours,

/s/

José Mario Vaz
Minister of Finance

**APPENDIX I**

## MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES FOR 2010-2012

## I. INTRODUCTION

1. Guinea Bissau is at a turning point. Following an extended period of political instability in the aftermath of the 1999 civil war, the Presidential election of September last year, and the civilian government of Prime Minister Carlos Gomes are significant markers toward much-needed political stability. This has allowed the government to move away from day-to-day business and to start focusing on developing and implementing a medium-term strategy of economic development and poverty alleviation. The country remains largely dependent on the agricultural sector, with a small domestic market and a narrow export base vulnerable to shocks. Poverty is widespread, with about two-thirds of households living below the poverty line.

2. The government is committed to pursue a medium-term economic program for 2010–12 that can help the country move towards fiscal and debt sustainability, as well as achieve stronger economic growth and poverty alleviation. The program focus on strengthening public finances; modernizing the public administration and rebuilding technical and policy implementation capacity; increasing access to social services and basic infrastructure; and developing the private sector. The program, which we are requesting be supported by Fund resources under the Extended Credit Facility (ECF), is consistent with the country's Poverty Reduction Strategy Paper (PRSP). Satisfactory performance under the program could pave the way for Guinea-Bissau to benefit from debt relief under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI).

## II. RECENT ECONOMIC DEVELOPMENTS AND PERFORMANCE UNDER THE EPCA SUPPORTED PROGRAM

### A. Recent Economic Developments

3. In 2009, growth slowed due to a less favorable external environment and an unstable political environment. Lower prices for the predominant export (cashews) and falling remittances led to a significant slowdown in incomes and exacerbated fiscal and balance of payment pressures. Still, with a favorable cashew harvest and a pick-up in construction activity, real GDP growth is estimated at about 3 percent last year, slightly higher than expected.

4. On the external front, a drop of cashew export receipts driven by lower cashew nut prices led the current account deficit (excluding grants) to deteriorate to 6½ percent of GDP (preliminary data). Export prices were down nearly 30 percent, offsetting a strong growth in export volumes amid the good cashew harvest (up 22 percent over 2008). Imports rose,

reflecting higher oil import volumes—despite lower average oil prices. Strong growth in the volume of construction materials was an additional source of pressure on the import bill, reflecting a pick-up in infrastructure projects. In addition to the deterioration in merchandise trade, the evolution of the current account was also affected by the decline in remittances (which represented about 4 percent of GDP in 2008). The increase in the current account deficit was largely financed by an increase in grants, both project and budget assistance. The result was a relatively modest deterioration in the overall balance.

5. The general price level came down in 2009 in light of a decline in the import price of food and the CFAF peg to the euro. Domestic inflation has remained subdued, despite a looser monetary policy stance in the WAEMU region. Private sector credit decelerated sharply reflecting a cautious approach by banks to new lending and a tight liquidity situation in the banking system, overburdened by a large stock of public sector arrears.

6. Guinea-Bissau continues to face a difficult fiscal situation. The low tax base and the high expenditures as a percent of domestic revenues, by regional standards, make public financial management rigid and leave almost no space to accommodate much needed social expenditures. Despite recent improvements in revenue and expenditure management, the financing of the budget continues to rely heavily on external budget support.

7. Fiscal performance, however, has been satisfactory despite the difficult external environment and unfavorable political situation. Better-than-expected revenue collection throughout the year partly compensated for delays in donor financing. Tax revenues overperformed by about 2 percentage points of GDP, reflecting the good cashew harvest and stepped up collection efforts. While through September Guinea-Bissau had received only 50 percent of the budget support pledged, by year-end donor support exceeded program levels with disbursements from the WAEMU, the EU, and France. Meanwhile, the government contained spending and kept domestic arrears within target.

## B. Performance under the EPCA Program

8. All but two EPCA quantitative assessment criteria were met through December. The ceiling on repayment of previous years' arrears was breached when the government decided to pay off 2008 wage arrears; non-regularized expenditures temporarily grew because of the mid-year elections, but have since been classified into the budget and the government is working to tighten norms with a view to curb them.

9. Progress on structural reforms accelerated toward the end of last year, but some targets were missed**.** The government has completed the biometric survey for civil servants; approved the annual progress report on the PRSP; drawn up the action plan for public financial management, and enacted the new investment code. Of the other measures, the government decided not to sign a contract with a pre-shipment customs inspection company and there were delays on two other measures. The automated system for customs administration will now be put into operation in three customs posts (Bissau, the airport, and

Safim) by July 2010. The unified payroll and payment system will be operational in two pilot ministries, the Ministry of Finance and the Ministry of Labor and Public Services, by January 2011.

## III. Policy Priorities and Main Objectives of Medium-Term Macroeconomic Program

10. The government's medium-term program aims at providing the basis for Guinea-Bissau to achieve fiscal and debt sustainability, as well as stronger economic growth and poverty alleviation.

11. Key macroeconomic objectives of the government program are to (i) raise real GDP growth to 4.5 percent by program end; (ii) contain annual inflation below 3 percent, in line with the WAEMU norm; and (iii) achieve a gradual narrowing of the external current account deficit (excluding official transfers). Over the medium-term, the pick-up in growth is to be driven by sustained cashew production; expanded and diversified agriculture (including rice); increased activity in cashew nut processing and industrial fishing, and steady rebuilding of public infrastructure, especially roads, electricity, and water. Supported by the exchange rate peg, inflation is expected to remain subdued, in line with global food and fuel prices.

12. The medium-term fiscal program will aim at strengthening fiscal policy and achieving debt sustainability. The strategy seeks to strengthen revenues─ Guinea-Bissau's revenue collection is low by regional standards─ and make space for priority spending, while keeping current year spending within available resources and starting to address domestic arrears. The fiscal program reduces the domestic primary deficit gradually to 3½ percent of GDP by 2012. This, combined with HIPC/MDRI debt relief, will improve fiscal and debt sustainability while limiting reliance on external budget support.

13. The 2010 budget is an important first step of the medium-term framework. The budget introduces strong revenue measures (through the elimination of custom duty suspensions on certain products), keeps current year spending within available resources, and protects priority spending. The budget targets a domestic primary budget deficit of 4 percent of GDP. Total revenues are expected to increase by 1¼ percent of GDP, due to elimination of custom duty suspensions on certain products and one-off increases in fishing compensation from the EU.[1] Domestic primary spending is projected to rise by 2¼ percent of GDP, reflecting higher capital outlays on infrastructure projects (about 1½ percent of GDP) and targeted increases in education, health, and agriculture. The higher current spending is modest compared to the needs to improve basic services.[2] Budget support of CFAF 13 billion

[1] EU fishing compensation will rise by 0.7 percent of GDP in 2010 to compensate for lower disbursements in 2009.

[2] The higher current spending in 2010 also takes into account the costs of local elections later in the year,

is expected mostly from the EU, the AfDB, the World Bank, and bilateral donors. The residual financing gap of CFAF 13.4 billion is expected to be filled by European Commission Vulnerability-Flex grant resources under the 2010 exercise (up to CFAF 9.8 billion) and the ECF (CFAF 3.6 billion). For contingencies, the government has a general budget reserve allocation of CFAF 0.5 billion, and the government is committed to further efforts to reduce spending, or recover additional revenues, to make up for any financing shortfalls.

14. The government has prepared a medium-term plan to address domestic arrears. Domestic arrears are sizable, and while estimates vary, the stock that has been identified accounts for about 23 percent of GDP at end-2009. These include wage arrears, arrears to domestic banks, the BCEAO, and commercial arrears to the private sector. Starting to address those arrears in the context of a credible medium-term strategy will go a long way in terms of restoring economic confidence, improving liquidity in the banking system, and alleviating social tensions. The government's plan has two steps. In the first step, it addresses well-identified and verified arrears, and the most costly to the budget. These include arrears to commercial banks and the BCEAO which entail high financial costs to the government, as well as wage arrears of 2008. These arrears have been settled with cash payments using available financing consisting of donor support, domestic currency loans from the BCEAO representing a local currency counterpart to the SDR allocation, and rescheduling. In the second step, the government intends to start addressing arrears to the private sector incurred up to 1999 and to complete the audit of 2000–07 arrears. In 2010, the government will carefully monitor budget execution and available resources before carrying out its plan of paying individual claims of up to about CFAF 30 million, for a total of CFAF 3.5 billion, and reschedule the remainder.

15. The government hopes that satisfactory performance under a Fund-supported program could pave the way for debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI). Guinea-Bissau reached the decision point under the HIPC Initiative in 2000, remains in debt distress, and has been in arrears to external creditors that have not provided interim debt relief. The authorities are committed to satisfying the remaining requirements to reach the HIPC completion point, including regularizing relations with all external creditors and meeting the HIPC completion point triggers. It would be important for Guinea-Bissau to reach the completion point before World Bank and African Development Bank interim debt relief expire.

## IV. Economic Reforms

16. The government's program of economic reforms centers on strengthening public finances; modernizing the public administration, creating space for priority spending, and raising the quality of public services; and removing impediments for private sector development.

**Strengthening public finances**

17. The reform agenda to strengthen public finances aims to raise revenue collection and improve public financial management.

## A. Strengthening Revenue Collection

18. A major element of the persistent fiscal imbalances in Guinea-Bissau is the low level of revenue compared with other sub-Saharan African countries, including countries in the WAEMU area. Revenues depend heavily on tax collection at customs (export and import duties, as well as sales tax on imports). Customs is therefore a major force in the process of tax collection, and measures to mobilize revenue will partly focus on improving customs administration, especially import processing and customs clearance. But efforts will also be required to broaden the tax base, including by shifting to a VAT in line with other WAEMU countries; and reinforcing tax administration.

19. To achieve its revenue collection targets, the government intends to work towards modernizing and improving the customs and tax administrations.

- On customs, the government plans to: (i) improve customs control and valuation by upgrading and putting into operation the Automated System for Customs Data (ASYCUDA ++) in all the main customs posts until June; (ii) introduce seals on alcoholic beverages and tobacco to combat smuggling; (iii) strengthen controls on warehouses and movements out of the port; and (iv) obtain better equipment for custom enforcement.

- On tax revenue, the government plans to: (i) strengthen controls of the sales tax by better monitoring of customs points of entry; (ii) reinforce the large taxpayer unit in the Ministry of Finance to ensure compliance with tax declarations; (iii) enforce the requirement that enterprises have a proper accounting system (SYSCOA); and (iv) better monitor small business tax payers, among others, through rigorous cross checks with import data.

20. The government aims to modify customs and tax policy with a view to enhancing revenue collection and broadening the tax base. In addition to the elimination of custom duty suspension on certain products (rice, wheat, sugar, cement, and other construction materials) effective since January 2010, the government plans to (i) conduct a comprehensive review of all custom exemptions with the goal to further broaden the customs revenue base; (ii) raise the reference price for cashew exports to US$ 750 per ton; (iii) increase the tax rate on the advance payment of the profit tax collected at customs (anticipation of industrial contribution) from 3 to 5 percent; and (iv) start preparing for a transition from the general sales tax to the VAT in line with other WAEMU countries. The move to the VAT will eventually contribute to broadening the tax base, as it would be levied on all imported goods

and services, helping spread out the payment of tax through a large number of businesses instead of being concentrated on particular groups. The government will request technical assistance from the IMF on tax policy, possibly through a resident advisor, to support its revenue mobilization efforts.

## B. Improving Public Expenditure and Financial Management

21. The government is committed to pursue public financial management reforms, revamping the monitoring, execution, and control apparatus seeking to achieve and maintain fiscal discipline; greater efficiency in public spending; more effective accountability; and better ability to mobilize and absorb resources. Reforms will be pursued in light of technical assistance and support received from the IMF and development partners in recent years, including the World Bank in the context of a Public Expenditure Management and Financial Accountability Review (PEMFAR), the AfDB, the EU and bilateral donors. The government will implement its PFM action plan approved by the Council of Ministers at the end of 2009, with measures focusing on better collection of tax payments, greater predictability in the availability of funds, more effective payroll controls and management, stronger controls in procurement, better dissemination of annual financial statements, and moving toward a multi-year perspective in fiscal planning.

**Better budget planning**

- All administrative revenues are now collected by the Treasury, but revenue sharing agreements (“restitutions”) between the collecting ministries (including allocated revenue from fishing, mining, and forestry; and administrative revenue such as revenue from passport) and the Treasury have resulted in de facto earmarking of resources. The government will review the legal framework that regulates restitutions by March 2011 with a view to increase the share of nonearmarked revenues in the budget.

- The government will prepare in 2010 a medium-term expenditure plan in line with the poverty reduction strategy.

**Greater predictability and control in budget execution**

- Standard budget execution procedures have often given way to non-standard or “simplified” ones to execute significant portions of the budget. Supporting documentation is not systematically provided to Treasury officers charged with making payments so that a crucial link between budget and treasury functions and the associated controls is routinely severed. The government will implement norms tightening the recourse to simplified spending procedures, with the goal that emergency spending is regularized within five days.

- Cash management has been done through a daily allocation of funds which does not ensure that adequate cash is available to pay for expenditures when they are due. This involves a risk of arrears accumulation, which could be exacerbated if the Treasury single account is not implemented rigorously. The government will strengthen the Treasury committee in the Ministry of Finance, tasked to prepare and control a quarterly and monthly Treasury plan with accurate and timely short term estimates of cash inflows and outflows, to improve cash flow management. The Treasury plan for the 2010 budget will be finalized by June 2010. The government will also ensure the proper functioning of the single Treasury account.

- The government will make its financial management system (SIGFIP) fully operational, integrating budget preparation and execution and using it for monitoring budget execution and Treasury operations. The budget preparation module (administrative account) is already operational; the accounting system at the Treasury will become operational by July; and connections to the customs and tax administration, with full accounting of commitments and payment orders, will be operational by December 2010.

**Strengthening accounting, recording, and reporting procedures**

- The government will strengthen the unit of public debt management, with a view to improving debt monitoring, including through the full use of the public debt management system (SYGADE).

- A new public finance law was approved by the Council of Ministers and it is expected to be approved by Parliament in June 2010.

- The government will continue to produce quarterly budget execution reports and strengthen their preparation using SIGFIP, and will publish and send them to the National Assembly.

**Reinforcing internal and external controls**

- The financial control unit (FCU), which conducts an ex-ante control of all government budget expenditure (i.e., before commitment, and before authorization) has been put directly under the Minister of Finance. This eliminates the conflict of interest with the budget directorate, allowing the FCU to better control and supervise the financial directorates in line ministries. By June, the government will approve a new organizational chart for the FCU, and will assign a number of delegates to line ministries.

- The government will modify the organic law for the Audit Court to harmonize it with the WAEMU directives. It will also work to submit on a timely basis to the Court of Accounts the budgetary execution accounts to be approved annually, which will thereafter be submitted to the National Assembly.

- Following the review of public procurement procedures, in the context of the World Bank PEMFAR, the government identified the need to update the existing procurement code with a view to harmonize it with WAEMU standards; and to establish a procurement regulatory body, with representatives from public and private sectors and the civil society, to supervise public procurement.

### C. Modernizing the Public Administration and Raising the Quality of Public Services

22. Civil service and public administration reform will be key to ensure medium-term fiscal sustainability and improve the quality of public administration. At present, the wage bill accounts for close to 60 percent of fiscal revenues, compared to 20 percent a decade ago, and well above the WAEMU convergence criteria. The wage bill grew rapidly earlier in the decade due to expansion of payroll and wage increases designed to decompress the salary structure and to integrate special allowances in wages, but it has declined gradually in recent years driven by a salary freeze. At about 20,000 public sector employees (including civil servants, paramilitary, and military, preliminary figures), the proportion of public servants in the population is the highest in the WAEMU region (about 13 public employees/thousand inhabitants, compared to 6-7 for the region).

23. The government will launch a broad civil service reform program aimed at achieving a more modern, efficient civil service. The reform will (i) significantly reduce the size of the civil service; and (ii) increase the efficiency of public administration by upgrading the qualifications and working conditions for civil servants. The Minister of Public Service and Labor is preparing a plan of action to be submitted to the Council of Ministers by end-2010. The plan will include a medium-term schedule with annual targets to downsize the civil service through mandatory retirement and removing redundant workers beginning in 2011. Key objectives will be to remove from the payroll into retirement all employees who exceed the mandatory retirement age; address the group of civil servants included in the excess pool of workers for reinsertion into the private sector, in the context of the EU Program to support Public Administration Reform (PARAP); and dismiss workers who account for overstaffing. The government will seek donor support for the civil service reform, and will use the savings in the wage bill to help cover the cost of severance payments.

24. To allow for adequate control, regular updating, and verification of civil service employment, the government is working to implement stricter payroll controls and establish a more comprehensive payroll database. By end-June, the government will (i) publish the verified data of the biometric census of civil servants and (ii) start paying the highest salaries through the banking system. By end-2010, the government will cross check and update the database of the Ministry of Finance with data from the census. By January 2011, the government will start using the computerized and unified payroll and personnel management system, and pilot it in the ministries of Finance and Public Service. The system will be extended to most ministries by March 2011.

25. Beyond reducing and enhancing control of the public sector wage bill, the public administration reform, to be supported by donors, is aimed also at improving the quality of public services. The government plan will focus on introducing effective management and control of public personnel expenditures; and increasing productivity by providing performance incentives, restructuring the job grading system, and enhancing training and management, in coordination with donors. A new school of public administration will be established with the help of the AfDB.

26. The government is also committed to modernizing the defense and security sector and restructuring it, including by demobilizing excess troops. The cost of defense and security forces is about 1/3 of the wage bill and the government is committed to reducing the burden on the budget of these large forces. The government effort comes after the demobilization, reinsertion, and reintegration program (DRRP) pursued at the end of the civil conflict in 1998-99; and follows the census of the armed forces conducted in 2008. A key specific objective is to reduce military forces gradually from 4500 soldiers to 3500 soldiers, of which, only 1500 (about 30 percent) will be permanent with the introduction of mandatory national service. This will be accomplished through retirement (about 2200) and demobilization for reinsertion into the private sector (about 800), with participants formally discharged from the armed forces, without the possibility of enlisting again. In addition, the government plans to rationalize the security forces, including the police, with the National Guard incorporating the several existing police forces. The government will create a pension fund, with the help of donors. The government is committed to partly using annual savings to the budget from retirement and demobilization to strengthen the pension fund. A broad donor coordination effort is underway to facilitate the mobilization of financing.

### D. Improving the Environment for Private Sector Development

27. The government program to remove impediments to private sector development has four main objectives: (i) improving the business environment; (ii) reforming the judicial system; (iii) restoring and developing basic infrastructures, in the areas of, power, transportation, and communication; and (iv) improving access to credit.

28. To improve the business and investment environment, the government will:

- Adopt the implementing regulations of the new Investment Code, which removes the multiplicity of investment regimes, eliminates the discretion of granting incentives under the old law, and provides for a level playing field for private investors.

- Speed up the work of the National Commission on the Simplification of Administrative Procedures, led by the Minister of Economy. The commission will present to the Council of Ministers a set of measures by June 2010 identifying and removing impediments to private sector development and improving the ease of doing business in Guinea-Bissau. As an important first step, the government has made progress towards establishing a one-stop shop for business, with World Bank support, and plans to have it approved by the Council of Ministers by June 2010. The one-stop-shop will be operational by the end of the year, with a view to simplifying and facilitating licensing and registration procedures for new businesses.

29. The government is committed to promoting good governance and increased transparency. In addition to procurement reforms (discussed above), the government will pursue reforms aimed at improving the quality of the judicial system in the context of an EU program of support in this area. The establishment of the commercial tribunal will facilitate the settling of commercial disputes. There has been progress on preparing the regulatory framework for telecommunications, and the government plans to put in place a telecommunications law that provides the legal framework for a rapidly expanding sector.

30. The government program of investments will focus on infrastructure for power, roads, and the port. The government will (i) improve capacity building and coordination with donors for broader and faster funding of infrastructure rehabilitation and expansion; (ii) increase fiscal space to cofinance investment projects; and (iii) review opportunities under the public-private partnership legal framework.

- The focus on infrastructure is on areas needed for private sector development. This includes projects that would allow the country to reduce the cost of existing operations (e.g., poor capacity of the port of Bissau), as well as projects that would allow the country to tap into its unexploited mineral resources (bauxite and phosphate), including possibly the need for a deep water port and railways. The Ministry of Economy will conduct studies in this area, including to inform and help better prepare its public investment program.

- To sustain spending on infrastructure it will be important to create fiscal space by containing non-priority discretionary spending, for much needed domestically financed capital spending and co-financing operations. The government will also reinforce the coordination of information across ministries to allow for better monitoring of execution of its Public Investment Program.

- The government will avail itself of the legal framework for public-private partnerships (PPP), put in place last year with support from the World Bank, with a view to reducing the infrastructure deficit in sectors such as ports, railway transportation, and energy. Effective use of public-private partnership legal frameworks will require not only improving the investment climate for potential investors, but also making sure that rebuilding and new infrastructure are in line with the capacity to pay for maintenance and operations; and do not create undue fiscal risks for the government.

## E. Improving Access to Social Services, Agriculture Policy, and Poverty Reduction

31. The government aims to make further progress towards addressing the high rates of poverty prevalent in Guinea-Bissau, in a manner consistent with the approach established in the country's Poverty Reduction Strategy. Increasing per capita income and reducing the incidence of poverty will require efforts in several fronts, including improving access to basic services (health and education) and agricultural development as most of the poor living in rural areas and practicing subsistence agriculture. The government has assessed its experience in implementing its 2007 PRS, and the lessons learned will inform the successor three-year PRS that is currently being prepared for completion in 2010.

32. Subject to further elaboration in the PRS, investments in the health and education of the population and the delivery of basic services will be government priorities. The low quality of basic social services in Guinea-Bissau reflects a lack of, and weak management of, resources. The government is committed to gradually increasing and sustaining spending on social sectors, health and education, with a view to not only providing the basis for economic development by enhancing the capacities of the poor but also to contributing to poverty reduction and lowering the vulnerability of the poor. This will require a deliberate effort in the budget, but also close cooperation with donors, including the World Bank, with a view to expanding the available resources in these areas. In 2010–2012, the government is committed to using at least 50 percent of tax revenues for current and domestically financed capital spending in health, education, agriculture, and infrastructure.

33. In the fight against poverty, agricultural development will also be critical. As Amilcar Cabral once said, in Guinea-Bissau agriculture is not only the basis of the economy, agriculture is the economy itself. Cashew nuts are the main source of income in rural areas, and operations in the cashew sector are labor-intensive, with income widely distributed among the population. The agricultural sector contribution to income generation could be greatly amplified if Guinea-Bissau were to diversify its agriculture, reduce the need for rice-for-cashew operations; and add value to the cashew sector by greater processing of cashew nuts and derivative products locally. In cooperation with donors the government will pursue investment projects in support of land recovery and equipment, and the government agricultural plan envisages the country gradually becoming self-sufficient in rice production.

## F. Financial Sector and Monetary Policies

34. Monetary policy will continue to be pursued within the framework of Guinea-Bissau's participation in the WAEMU, an arrangement that has enabled the country to contain inflation and maintain a stable exchange rate.

35. Access to credit is still low. The settlement of government arrears to domestic banks improves their liquidity position and available funds for domestic credit operations. The government is seeking donor assistance for improving availability of credit for small and medium size enterprises. To help combat money laundering, the government will present a

law to combat the financing of terrorism to the Council of Ministers in June 2010, and it will better equip the National Center for the Treatment of Financial Information (CENTIF).

## G. External Debt Management

36. Guinea-Bissau has been in debt distress for many years, and has accumulated sizable arrears to external creditors. The government will act in good faith to regularize its relations with its external creditors. It intends to improve its debt management capacity and organization. The government will maintain communication with those creditors to which it has arrears, aimed at reaching agreements that would allow it to normalize relations in a manner consistent with the country's debt service capacity.

37. The government will pursue a prudent debt management strategy. For the full duration of the three year program, the government will not contract or guarantee any nonconcessional or short-term external debt, as defined in the Technical Memorandum of Understanding (TMU). Moreover, the government will refrain from all external borrowing on non-concessional terms, and any government or government-guaranteed borrowing (external or domestic) will be subject to prior approval by the Finance Minister.

38. Achieving HIPC and MDRI debt relief will be critical for improving medium-term external sustainability. Guinea-Bissau reached the HIPC decision point in 2000. At that time, creditors pledged to provide debt relief equivalent to 85 percent cancellation in NPV terms. However, interim debt relief by the Fund and Paris Club creditors stopped after 2001, when the PRGF-supported program went off-track. The African Development Bank (AfDB) and IDA continue to provide interim debt relief, which expire at end-2010 and early 2011, respectively. Since 2001, Guinea-Bissau has not repaid any creditor that did not provide interim relief, with the exception of the IMF. Reaching the HIPC completion point and receiving MDRI debt relief would significantly reduce the burden of debt. It is crucial however, that Guinea-Bissau reaches the completion point by the end of 2010, before World Bank and African Development Bank interim debt relief expire. In the months ahead, the government will assist the efforts by the IMF and the World Bank to update the existing HIPC completion point triggers.

## H. Statistics

39. The government will publish revised national account data for 2003–08, based on the SNA93, in the second quarter of 2010. The new data have a broader coverage of all the sectors in the economy, and have led to a doubling of the GDP level. The government plans to start producing national account statistics based on SNA08, with technical assistance from international and regional institutions.

## I. Capacity Building and Technical Assistance

40. Capacity building is a key complement to fiscal reforms in order to ensure their effectiveness and sustainability. Several partners are providing technical assistance in areas of public financial management as well as macroeconomic statistics. The highest priorities are assistance to the Customs, Treasury, Budget, and Tax departments. The IMF is providing technical support, including technical assistance from West AFRITAC and AFRISTAT, in the areas of public financial management and national accounts statistics.

## J. Program Monitoring

41. The first year of the program covers the 12 months from January 1, 2010, to December 31, 2010. It will be monitored using quarterly quantitative indicators and structural benchmarks, as well as the semi-annual reviews and quantitative performance criteria presented in Tables 1, and 2. Table 3 contains a list of main structural measures identified by the government. The definitions of quantitative performance criteria and benchmarks are provided in the attached TMU. We expect the first review to be completed by November 2010 and the second review to be completed by May 2011.

**Table 1. Guinea-Bissau: Quantitative Indicators for the ECF program for 2010**

Quarterly Targets [1]

(Cumulative, CFAF millions)

| | End-March | End-June | End-Sept. | End-Dec. |
|---|---|---|---|---|
| | Prog. | Prog. | Prog. | Prog. |
| **Performance Criteria**[2] | | | | |
| 1. Domestic financing of the budget | 7,165 | -1,411 | 3,430 | 231 |
| 2. New domestic arrears | 0 | 0 | 0 | 0 |
| 3. External nonconcessional public borrowing, maturity > 1 year | 0 | 0 | 0 | 0 |
| 4. External short term public borrowing | 0 | 0 | 0 | 0 |
| **Indicative Targets** | | | | |
| 5. Government tax revenues | 5,420 | 15,148 | 24,218 | 30,101 |
| 6. Domestic primary balance (commitment basis) | -7,789 | -6,779 | -11,030 | -16,333 |
| 7. Nonregularized expenditures (DNTs) | 200 | 200 | 200 | 200 |
| 8. Social and priority spending | 4,062 | 8,123 | 12,185 | 16,246 |

[1] Cumulative from January 1. The definition of the aggregates and adjustors is provided in the Technical Memorandum of Understanding (TMU).

[2] All Performance Criteria (PC) are ceillings and PC 3 and 4 apply continously.

**Table 2. Guinea-Bissau: Structural Benchmarks**
**Under the Extended Credit Facility**
January 1, 2010–December, 31, 2010

| Category | | Structural Benchmarks | Macro Rationale | Delivery Date | Ministry |
|---|---|---|---|---|---|
| | | First Review | | | |
| Fiscal Management | 1 | Prepare quarterly and monthly Treasury plans and make operational the Treasury committee within the Ministry of Finance. (¶21) | To improve budget planning | June 2010 | MoF[1] |
| | 2 | Implement norms tightening the recourse to simplified spending procedures. (¶21) | Greater control in budget execution | May 2010 | MoF |
| | 3 | Make operational the accounting system at the Treasury under the SIGFIP. (¶21) | Greater control in budget execution | July 2010 | MoF |
| Tax Reform & Strengthening Revenue Collection | 4 | Put into operation the Automated System for Customs Data (ASYCUDA ++) in three customs posts (Bissau, airport, and Safim). (¶19) | To strengthen revenue collection | July 2010 | MoF |
| Expenditure Reforms | 5 | Publish the verified data of the biometric census of the public administration employees (civil servants and paramilitary). (¶24) | To improve civil servant management | June 2010 | MinLaPS[2] |
| Business Environment | 6 | The Council of Minister will approve a legal framework for the "one-stop" shop streamlining procedures and reducing cost for licensing and registration of new businesses. (¶28) | Improve the ease of doing business | June 2010 | MinEcon[3] |
| | | Second Review | | | |
| Fiscal Management | 7 | Establish an operational link from budget/Treasury under the SIGFIP to the customs and tax administration. (¶21) | Greater control in budget execution | Dec 2010 | MoF |
| Expenditure Reforms | 8 | Submit to the Council of Ministers an action plan for the public administration reform, with a medium-term schedule to downsize the civil service through retirement and removing redundant workers beginning in 2011. (¶23) | To improve the efficiency of civil service | Jan 2011 | MoF/ MinLaPS |
| | 9 | Start using the unified payroll and personnel management system, and pilot it into the Ministry of Finance and the Ministry of Labor and Public Services. (¶24) | To modernize public administration | Jan 2011 | MoF |

[1] Ministry of Finance
[2] Ministry of Labor and Public Services
[3] Ministry of Economy

**Table 3. Guinea-Bissau: Structural Measures**
**Under the Extended Credit Facility**

| Category | | Measures | Delivery Date |
|---|---|---|---|
| Tax Reform & Strengthening Revenue Collection | 1 | Put into operation the Automated System for Customs Data (ASYCUDA ++) in three customs posts (Bissau, airport, and Safim). (¶19) | Jul 2010 |
| | 2 | Introduce seals on alcoholic beverages and tobacco. (¶19) | 2010 |
| | 3 | Strengthen controls on warehouses and movements out of the port. (¶19) | 2010 |
| | 4 | Obtain better equipment for custom enforcement. (¶19) | 2010 |
| | 5 | Strengthen controls of sales tax by better monitoring of customs points of entry. (¶19) | 2010 |
| | 6 | Reinforce the large taxpayer unit in the Ministry of Finance. (¶19) | 2010 |
| | 7 | Enforce that enterprises have a proper accounting system (SYSCOA). (¶19) | 2010 |
| | 8 | Improve monitoring of small business tax payers through rigorous cross check with import data. (¶19) | 2010 |
| | 9 | Conduct comprehensive review of all customs exemptions. (¶20) | 2010 |
| | 10 | Raise reference price for cashew exports to US$ 750 per ton. (¶20) | 2010 |
| | 11 | Increase the tax rate on advance payment of the profit tax collected at customs (anticipation of industrial contribution) from 3 to 5 percent. (¶20) | 2010 |
| | 12 | Start preparing for transition from the general sales tax to the VAT. (¶20) | 2010 |
| | 13 | Review the legal framework that regulates revenue sharing agreements (“restitutions”), with a view to increasing the share of non-earmarked revenues in the budget. (¶21) | Mar 2011 |
| Fiscal Management | 14 | Prepare a medium-term expenditure plan in line with the PRS. (¶21) | 2010 |
| | 15 | Implement norms tightening recourse to simplified spending procedures. (¶21) | May 2010 |
| | 16 | Prepare quarterly and monthly Treasury plans and make operational the Treasury committee within the Ministry of Finance. (¶21) | Jun 2010 |
| | 17 | Make operational the accounting system at the Treasury under the SIGFIP. (¶21) | Jul 2010 |
| | 18 | Ensure the proper functioning of the single Treasury account. (¶21) | 2010 |
| | 19 | Establish an operational link from budge/Treasury under the SIGFIP to the customs and tax administration. (¶21) | Dec 2010 |
| | 20 | Strengthen the unit of public debt management, including through the full use of the public debt management system (SYGADE). (¶21) | 2010 |
| | 21 | Continue to produce quarterly budget execution reports, and strengthen its preparation using SIGFIP. (¶21) | 2010 |
| | 22 | Approve a new organizational chart for the FCU, and assign a number of delegates to the line ministries. (¶21) | Jun 2010 |
| | 23 | Modify the organic laws for the Audit Court. (¶21) | 2011 |
| | 24 | Update existing procurement code and to establish a procurement regulatory body. (¶21) | 2010 |

| | | | |
|---|---|---|---|
| Civil service reform | 25 | Publish the verified data of the biometric census of public administration employees (civil servants and paramilitary). (¶24) | Jun 2010 |
| | 26 | Start paying the highest salaries through the banking system. (¶24) | 2010 |
| | 27 | Cross–check and update the database of the Ministry of Finance with data from the census. (¶24) | End-2010 |
| | 28 | Start using the computerized and unified payroll and personnel management system, and pilot it into the ministries of Finance and Public Service. (¶24) | Jan 2011 |
| | 29 | Extend the computerized and unified payroll and personnel management system to other ministries. (¶24) | Mar 2011 |
| Defense and security sector reform | 30 | Create a pension fund, with the help of donors. (¶26) | 2010 |
| | 31 | Prepare a plan to rationalize the security forces, including the police, with the National Guard incorporating the several existing police forces. (¶26) | 2010 |
| Arrears Clearance | 32 | Complete the audit of 2000–07 private sector arrears. (¶14) | 2010 |
| Business Environment | 33 | Adopt regulations implementing the new Investment Code. (¶28) | 2010 |
| | 34 | The Council of Ministers will approve a legal framework for the "one-stop" shop streamlining procedures and reducing cost for licensing and registration of new businesses. (¶28) | Jun 2010 |
| | 35 | Improve capacity building and coordination with donors for broader and faster funding of infrastructure rehabilitation and expansion. (¶30) | 2010 |
| | 36 | Increase fiscal space to cofinance investment projects. (¶30) | 2010 |
| | 37 | Review opportunities under the public-private partnership legal framework. (¶30) | 2010 |
| Social Services, Agriculture Policy, and Poverty Reduction | 38 | Prepare a new PRS. (¶31) | 2010 |
| | 39 | Keep at least 50 percent of tax revenues for health, education, agriculture, and domestically financed capital spending. (¶32) | 2010-12 |
| | 40 | Pursue investment projects in support of land recovery and equipment. (¶33) | 2010 |

**APPENDIX II**

**TECHNICAL MEMORANDUM OF UNDERSTANDING**

Bissau

March 11, 2010

1. **This memorandum describes the definitions of the quantitative and structural performance criteria, indicative targets, and structural benchmarks to monitor the program supported by an arrangement under the Extended Credit Facility (ECF).** It also specifies the agreed periodicity and deadlines for transmission of data to IMF staff for program monitoring purposes.

## I. Quantitative Indicators and Adjustors

### A. Quantitative Indicators

2. **The quantitative indicators are the following:**

a. Cumulative floors on government tax revenue

b. Cumulative ceilings on the domestic primary fiscal deficit (on a commitment basis)

c. Cumulative ceiling on the amount of nonregularized expenditures (DNTs).

d. Cumulative floor on social and other priority spending

e. Cumulative ceilings on the change in net domestic financing of the budget

f. Cumulative ceiling on new domestic arrears of the government, including wage arrears

g. Cumulative ceilings on new nonconcessional external debt contracted or guaranteed by the government

h. Cumulative ceiling on new external short term debt.

Quantitative indicators are set for end-March, end-June, end-September, and end-December. Quantitative performance criteria are proposed for end-June and end-December 2010 for indicators (e) through (h). Indicators for new nonconcessional external debt, and new external short term debt are continuous.

**Definitions and computation**

3. **For program purposes the government is defined as the central government of Guinea-Bissau.** This definition excludes public entities whose budget is not included in the central government budget.

4. **The targeted floor on government tax revenues** includes direct and indirect taxes, as well as recovery of tax arrears and additional revenue efforts (Table 1).

Table 1. Quarterly Floors for Government Tax Revenues, 2010
(Cumulative, CFAF millions)

| | March Prog. | June Prog. | Sept. Prog. | Dec. Prog. |
|---|---|---|---|---|
| Tax revenues | 5,420 | 15,148 | 24,218 | 30,101 |

5. **The domestic primary fiscal deficit on a commitment basis** is calculated as the difference between government revenue and domestic primary expenditure on a commitment basis (Table 2). Government revenue includes all tax and nontax receipts and excludes external grants. Domestic primary expenditure consists of current expenditure plus domestically financed capital expenditure, excluding all interest payments. Government commitments include all expenditure for which commitment vouchers have been approved by the Ministry of Finance; automatic expenditure (such as wages and salaries, pensions, utilities, and other expenditure for which payment is centralized); and expenditure by means of offsetting operations.

Table 2. Quarterly Domestic Primary Balance, New Domestic Arrears,
and Nonregularized Expenditures, 2010
(Cumulative, CFAF millions)

| | March Prog. | June Prog. | Sept. Prog. | Dec. Prog. |
|---|---|---|---|---|
| Total domestic primary deficit | -7,789 | -6,779 | -11,030 | -16,333 |
| Revenue | 6,972 | 22,890 | 33,526 | 42,993 |
| Domestic primary expenditure | 14,761 | 29,670 | 44,556 | 59,327 |
| New domestic arrears | 0 | 0 | 0 | 0 |
| Nonregularized expenditures (DNTs) | 200 | 200 | 200 | 200 |

6. **New domestic arrears of the government** are defined as accounts payable (rest-a-payer) accumulated during the year, still outstanding one month after the quarter for wages and salaries (including pensions), and three months after for goods and services and transfers, at end-March, end-June, end-September, and end-December 2010.

7. **Nonregularized expenditures** are defined as any Treasury outlay not classified in the expenditure tables presented by the National Budget Directorate.

8. **Net domestic financing consists of bank and nonbank financing** (Table 3). Bank financing consists of net changes in the balances of the Treasury accounts at the BCEAO (excluding net disbursement from the IMF) and commercial banks (excluding balances in those accounts that are not available for budget financing, such as accounts held under

double signature arrangements with donors) and in the outstanding amounts of loans, including T-bills, from the BCEAO and commercial banks, local and regional. Nonbank financing encompasses privatization receipts and any other financial debt held outside the banking system other than new domestic arrears.

Table 3. Domestic Financing by Quarter, 2010

(Cumulative, CFAF millions)

| | March | June | Sept. | Dec. |
|---|---|---|---|---|
| | Prog. | Prog. | Prog. | Prog. |
| Domestic financing | 7,165 | -1,411 | 3,430 | 231 |
| Bank financing | 7,165 | -1,411 | 3,430 | 231 |
| BCEAO | 18,130 | 9,554 | 14,395 | 11,196 |
| Commercial banks (including regional) | -4,225 | -4,225 | -4,225 | -4,225 |
| Regional commercial banks and Treasury bills | -6,740 | -6,740 | -6,740 | -6,740 |
| Nonbank financing | 0 | 0 | 0 | 0 |

9. **The indicators for external debt are cumulative ceilings on new nonconcessional external debt contracted or guaranteed by the government**. External debt is defined as debt held by creditors outside the WAEMU region. For ECF purposes, the definitions of "debt" and "concessional borrowing" are as follows:

a. **The indicator for external borrowing** applies to debt including commitments contracted or guaranteed for which value has not been received. The term "debt" is understood to mean a current liability, not contingent, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services that requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being (i) loans, that is, advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans, and buyers credits) and temporary exchanges of assets that are equivalent to fully collateralized loans, under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, that is, contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and (iii) leases, that is, arrangements under which property is provided that the lessee has the right to use for one or more specified periods of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. The debt is the present value at the inception of the lease of all lease payments expected to be made during the period of the agreement, excluding those that cover the operation, repair, or maintenance of the property. Under this definition of debt, arrears, penalties, and judicially awarded damages arising from failure to make payment on a contractual obligation that constitutes debt are also debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt. For the purposes of monitoring the ECF, arrangements to pay over time obligations arising from judicial awards to external creditors do not constitute nonconcessional external borrowing.

b. **Loan concessionality,** for program purposes, is assessed based on its calculated grant elements. A debt is concessional if it includes a grant element of at least 50 percent, calculated as follows: the grant element of a debt is the difference between the present value (PV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt. The PV of debt at the time of its contracting is calculated by discounting the future stream of payments of debt service due on this debt. The discount rates used for this purpose are the currency specific commercial interest reference rates (CIRRs), published by the Organization for Economic Cooperation Development (OECD). For debt with a maturity of at least 15 years, the ten-year-average CIRR will be used to calculate the PV of debt and hence, its grant element. For debt with a maturity of less than 15 years, the six-month average CIRR will be used. To both the ten-year and six-month averages, the same margins for differing repayment periods as those used by the OECD need to be added (0.75 percent for repayment periods of less than 15 years, 1 percent for 15 to 19 years, 1.15 percent for 20 to 29 years, and 1.25 percent for 30 years or more).

10. **Ceiling on short-term external debt newly contracted or guaranteed by the government**. Short-term external debt is debt with the contractual term of less than one year. Debt-relief operations and treasury bills issued in CFA francs on the WAEMU regional market are excluded from this performance criterion. In the context of the program, the government and public enterprises will not contract, or guarantee, short-term external debt. This performance criterion is monitored on a continuous basis.

11. **The concept of government for the purposes of the indicators on external debt is broader than the one used for the budget aggregates**; it includes all debt that may ultimately be deemed to be a liability of the state. In addition to the central government, the definition includes administrative public institutions; public enterprises authorized to contract, guarantee, or accommodate nonconcessional borrowing; scientific and technical public institutions; professional public institutions; industrial and/or commercial public institutions; and local governments.

12. **Social and other priority spending** is defined as total current expenditures in the education, health, and agricultural sector, and domestically financed capital spending (Table 4).

Table 4. Social and Priority Spending[1] by Quarter, 2010
(Cumulative, CFAF millions)

| | March Prog. | June Prog. | Sept. Prog. | Dec. Prog. |
|---|---|---|---|---|
| Social and other priority spending | 4,062 | 8,123 | 12,185 | 16,246 |
| Education | 1,788 | 3,575 | 5,363 | 7,151 |
| Health | 1,012 | 2,023 | 3,035 | 4,047 |
| Agriculture | 555 | 1,111 | 1,666 | 2,221 |
| Infrastructure | 707 | 1,414 | 2,121 | 2,828 |

[1] Current and domestically financed capital spending.

## B. Adjustors

13. **The following adjustors will be in effect**:

a. The ceiling on the domestic primary deficit (on a commitment basis) will be increased in case of lower than programmed disbursement of EU fishing compensation, by the amount of the shortfall up to a maximum of CFAF 3 billion. The program assumes the following amounts of EU fishing compensation (cumulative from January 1, 2010): zero by end-March; by end-June CFAF 4.59 billion; by end-September CFAF 4.59 billion; and by end-December CFAF 6.2 billion.[1]

b. The ceiling on domestic financing will be increased for any shortfall in external budget support, and EU V-Flex and fishing compensation, by the amount of the shortfall up to a maximum of CFAF 12 billion. The program assumes the following amounts of external budget support, and EU V-Flex and fishing compensation (cumulative from January 1, 2010): by end-March CFAF 5.3 billion; by end-June CFAF 16.2 billion; by end-September CFAF 16.2 billion; and by end-December CFAF 28.9 billion.

c. The ceiling on domestic financing for March, June, and September will be increased for payment of previous years arrears in excess of programmed amounts up to a maximum of CFAF 3.5 billion. The program assumes the following arrears payments from previous years (cumulative from January 1, 2010): by end-March CFAF 4.1 billion; by end-June CFAF 4.1 billion; by end-September CFAF 4.1 billion; and by end-December CFAF 7.9 billion.

[1] For the purposes of the TMU, the CFAF/Euro exchange rate is 655.956 and the CFAF/US$ exchange rate was updated to 450.

## II. Program Monitoring

14. **To allow monitoring of the program, the Ministry of Finance will regularly report the following information to the staff of the IMF**:

a. Detailed reports on revenue and expenditure by budget line and a completed summary table on central government operations (TOFE) (monthly, two weeks after the end of the month)

b. Data on any extra budgetary expenditure, including (i) incentives to tax collectors; (ii) restitutions to collecting agencies; and (iii) any other retentions operated by collecting agencies (DGA, DGCI, Fishing Ministry, etc.) (monthly, two weeks after the end of the month

c. Tables on nonregularized expenditures (monthly, two weeks after the end of the month)

d. Table on accounts payable broken down by budget category (wages, goods and services, transfers, other) (monthly, two weeks after the end of the month)

e. Previous years' domestic arrears (including 2009): stock and clearance, broken down by budget category (wages, goods and services, transfers, other) (monthly, two weeks after the end of the month)

f. The monetary survey, the balance sheet of the central bank, and the balance sheet of commercial banks (monthly, within six weeks after the end of the month)

g. A table with data on Treasury/central government outstanding loans (including short-term advances) from and deposits in local and regional commercial banks and T-bills (monthly, two weeks after the end of the month)

h. The amount and terms of new external debt (concessional or not) contracted or guaranteed by the government (within four weeks after the end of the month)

i. A monthly table on disbursements of budget support (grants and loans) by donors (two weeks after the end of the month)

j. Indicators to assess overall economic trends, such as the household consumer price index and exports of cashew nuts (immediately when such information becomes available)

k. A table with a description of the status of implementation of the structural indicators in Table 2 of the MEFP (within two weeks after the end of the month)

l. Information on any type of financial assistance received and not programmed. This should be reported on a continuous basis.

m. The Ministry of Finance will provide the staff of the IMF with any other information that the Ministry or the staff of the IMF deem necessary for program-monitoring purposes.