

**WEST AFRICAN MONETARY AGENCY
(WAMA)**



ECOWAS MONETARY COOPERATION PROGRAMME

***MACROECONOMIC CONVERGENCE REPORT
2007 CAP VERT***

FREETOWN, JUNE 2008

The state of Cape Verde's economy at the end of 2007, could be described as satisfactory even though there was a drop in economic growth in comparison to 2006 figures and general growth projections. The projected growth rate was initially set at 6.9%, however 6.6% was actually achieved. Inflation fell to 4.5%, notwithstanding the fact that it was against the backdrop of a generally difficult international situation. A sector analysis would give us a better insight into the economic and financial situation of Cape Verde.

1 Sector analysis

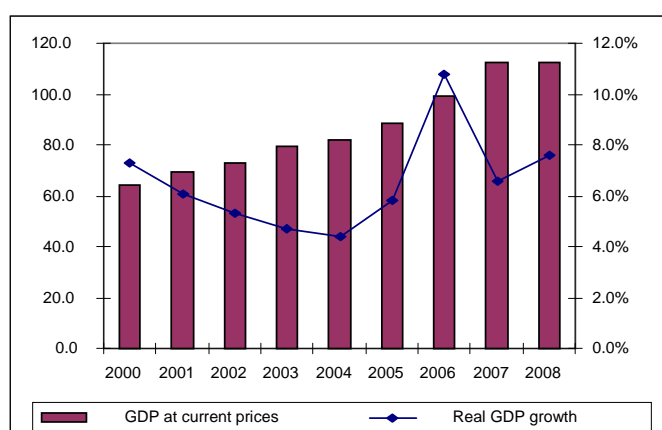
1.1 Real sector

The Cape Verde economy grew at 6.6 percent in 2007 after recording a growth rate of 10.8 percent in 2006. This continued vibrant growth reflects a relatively significant rate of implementation of Public Investment Programmes and the buoyancy of the private sector. This was sustained by a surge in domestic private credit and investment as well as substantial inflows of foreign direct investments (FDIs). The relative slowing down of GDP growth in 2007 is mainly explained by the fact that public investment inflows were less substantial than expected. Also in 2007, rainfall continued to be scanty and irregular for the third consecutive year and the production of irrigated maize, the main staple crop, dropped to one third of the volume recorded in 2006. Already, that year's harvest had been 46 percent lower than the average recorded over the previous five years. However, overall economic growth remained largely unscathed because agriculture accounts for less than 10 percent of GDP.

Unlike agriculture, commercial fishing showed great potential for expansion, especially since the European Union lifted its ban on fish imports from Cape Verde in 2005. Two major international fishing zones surround the Cape Verde islands which are spread over an area of about 630 000 kilometres squared of ocean rich in fish and shellfish species. Fishing accounts for a significant proportion of the country's exports, however, it represents only 1 percent of GDP as traditional methods are still being used.

With regard to services, trading, transportation, tourism and the public sector accounted for over 74% of GDP in 2006. Tourism is the main source of growth and offers great prospects for further diversification. Cape Verde is becoming an increasingly valued tourist destination. This sector is undergoing a rapid growth (+12.7% between 2000 and 2003 and +15% from 2004 to 2007). Tourism accounted for 18.3% of GDP in 2006 and provided employment for 53 000 people. Concerning the construction sector, it is made up of many small enterprises operating in the residential or commercial real estate sector as well as several big companies which undertake mainly infrastructure projects. Construction and public works propelled growth in this sector from 7.7% of GDP in 2004 to 9.3% in 2006. This sector was behind the growth of the entire economy. It was mainly driven by the development of tourism and to a large extent by the implementation of PIP.

Graph 3.53 : Trends in Nominal GDP and Real Growth Rate



Economic growth in 2007 was spread among the various components of final demand as indicated in the table below.

In 2006, inflation measured by the consumer price index rose rapidly, reaching 6% due to the rising prices of foodstuffs and petroleum products after settling at 1% on the average between 2001 and 2005. In the case of foodstuffs, the upward trend in prices is attributed to the shortfall in rainfall and the escalation of prices on the world market. Petroleum product prices also went up as a result of the escalation of prices on international markets. However, in 2007, inflation fell to 4.5% in spite of the slight relaxation of monetary policy, as the BCV (Central Bank) reduced the mandatory reserve coefficient from 15 to 14%. The prices of fresh food products actually declined and the VAT rate was reduced temporarily for some categories of consumer goods.

1.2 Public Finances

The overall budget of Cape Verde worsened in 2006 but recovered sharply in 2007, reflecting a slight deficit which would remain at a similar level in 2008 and 2009. The State budget was largely financed with official development assistance (ODA). It is worth noting that Cape Verde improved its tax system thanks to reforms and more efficient tax collection methods. Tax revenues went up from about 17% of GDP in 1999 to about 23% in 2006 and 2007. Total revenues also improved as a result of special revenues raised. This increase is largely due to non recurrent revenues accruing from the privatization of about thirty state enterprises. This is also as a result of reforms aimed at rationalizing tax laws and widening the tax net by harmonizing incentives and exemptions as well as customs duties and consumption taxes. Grants remained an important source of public revenue. They accounted for about 6% of GDP in 2006 and in 2007. Together with foreign loans, they finance 80% of the PIP. The improvement in public finance management raised donor confidence, leading to an increase in budgetary support from 4% of total budget in 2006 to 7% in 2007. With regard to net total expenditures and net borrowings, they stood at 34% of GDP in 2007 representing a slight regression compared 2006 (35.5%). This decline brought the total budget deficit (including grants) to 2.3% of GDP in 2007 against 4.6% in 2006. Cape Verde is highly dependent on oil imports and the State provides subsidies for electricity consumption in the public service. The escalation of crude oil prices on the international market is likely to adversely affect the State budget.

Graph 3.54 : Trends in Current Revenues and Expenditures



As regards debt, a recent IMF and World Bank study on debt sustainability indicated that Cape Verde continue to show a low risk of default in payments. The country's target was to achieve and maintain a maximum public debt ratio of 70% in relation to GDP (72.4% for 2006) whilst the domestic debt ratio would settle around 20% of GDP by end 2008 (against more than 33% at end of 2005).

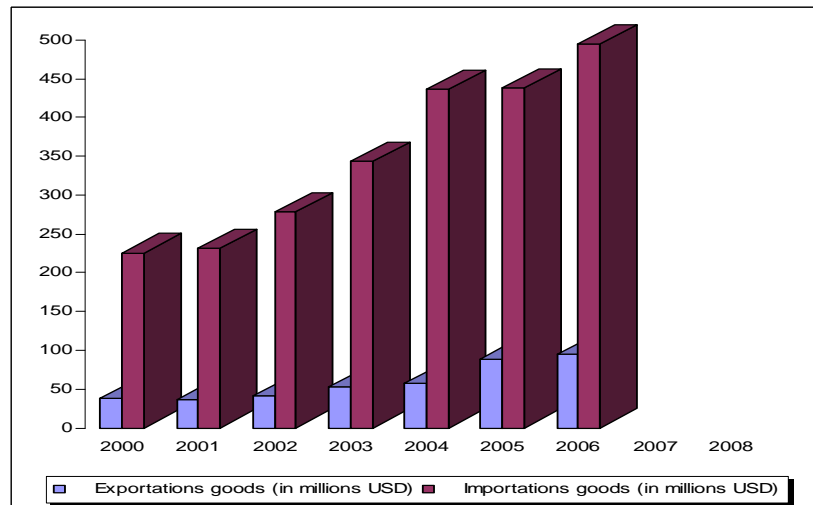
Consequently, external debt would drop from 32.7% of GDP at the end of 2005 to 25% at end 2007. As part of efforts to settle arrears payments of the central and local administration, the authorities undertook to pay oil companies (Shell Oil) part of outstanding subsidies in respect of fuel supplies to Electra, the state electricity and water companies. The total subsidy arrears would be settled in three instalments by 2009.

1.3 External Sector

In 2007, Cape Verde's main trading partners were Portugal, Netherlands, France, Brazil, Spain, Italy and Sweden. The country's imports come mainly from Portugal, representing 45% of total imports in 2007. It is followed by Netherlands with 16%. Portugal is also the leading importer of Cape Verde products ahead of Spain. It absorbs more than 50% of exports from the archipelago. Even though countries in the Euro Zone will remain its main trading partners, Cape intends strengthening South-South cooperation especially with Brazil as well as China and in the medium term with South Africa, India and Nigeria.

According to estimates, the current accounts deficit worsened in 2007 to settle at an unprecedented level due mainly to the down turn in export of goods and remittances from nationals leaving abroad. Between 2008 and 2009, this deficit would decrease gradually. The structural deficit of current accounts is explained by the country's strong dependence on goods imports which far outweigh exports. Whilst fish exports which accounted for 14% of total exports in 2006 was growing at the fast pace, the re-exportation of fuels remained low especially as a result of management problems and technical difficulties facing two companies, Enacol and Shell, which are unable to stock enough products. The deficit for trade in goods remained stable, given the positive trends in tourism revenue and the surplus of trade in services which increased significantly. The deficit of trade in goods and services was financed by foreign direct investments, foreign aid and remittances from migrant workers. These workers constitute an important Diaspora of about 700 000 people.

Graph 3.55: Trends in Imports and Exports



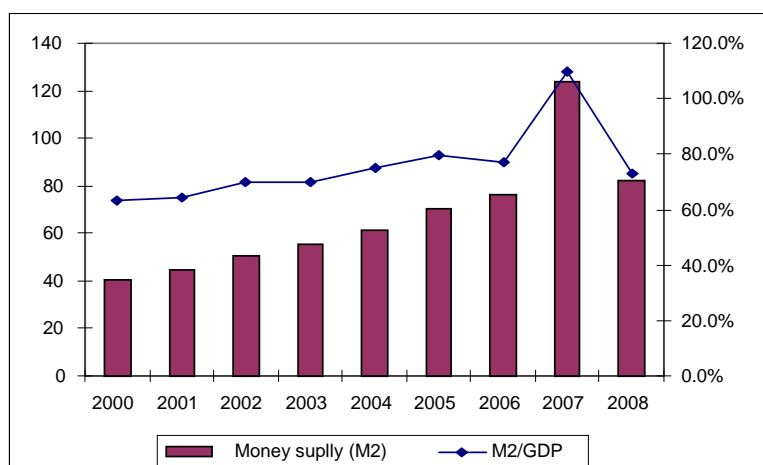
Cape Verde's external debt increased considerably between 1997 and 2001 following a downward trend in concessional grants and loans. Its share of GDP fell to 48% in 2006 against 56.5% in 2001. Over the same period the public debt servicing over exports of goods and services ratio dropped from 14.2% to 5.7%. The World Bank (through the International Development Association – IDA) is the leading multilateral donor ahead of Portugal, the main bilateral donor. The total external debt, including private sector debt followed the same trend. Its share of GDP declined to 63% in 2006 against 71.2% in 2001 and debt servicing over exports ratio dropped from 15.8% to 11.7% in 2006. Cape Verde's loan ranking shows an improvement in the solvency of the country, thus reflecting a low risk of default in payments.

1.4 Monetary Sector

In 2006 and 2007, Cape Verde Central Bank (– BCV)'s objective was to improve the credibility of the exchange regime where the escudo is tied to the euro in order to contain inflation. Given the importance of foreign remittances and their sensitivity to exchange rate variations, BCV (Banco Central de Cabo Verde) raised its key rate by 5% in line with trends in the refinancing rate of the European Central Bank. Gross external reserves reached over CVE 2.9 million at end of 2007 (against CVE 2.1 million in 2006), representing the equivalent of 3.2 months of imports. Though Cape Verde did not liberalize its capital account, it encouraged FDI by simplifying registration procedures (investors only need to notify the BVC on how they intend to invest their funds). Dividends for the first five years are 100% tax exempt (the tax rate is 10% afterwards). The same applies to dividends and earnings reinvested in the country as well as capital allowances and interests. It also allows foreign investors to acquire interests in privatized companies.

It is worth recalling that a law was passed in May 2002 prohibiting the Central Bank to finance budget deficit, Cape Verde was not compelled to resort to monetary financing of the Central Administration budget deficit thanks to the budgetary support provided by donor and the sale of treasury bonds (maturing in 2014) helped in raising the necessary financial resources.

Graph 3.56 : Trends in Money Supply



2 Performance in terms of macroeconomic convergence

On the whole, Cape Verde's economic performance indicators were promising at end of 2007. The overall level of performance improved, with the number of criteria increasing from four (4) at end 2006 to 5 as at end June 2007. (See Table below).

CAPE VERDE : CONVERGENCE POSITION	2001	2002	2003	2004	2005	2006	2007*	2008**
Primary criteria:								
i) Budget deficit/GDP	9.0	11.3	9.1	13.0	12.7	8.6	11.8	11.5
ii) Inflation Rate	4.2	3.0	-2.3	-0.3	1.7	5.8	3.4	6.0
iii) Budget deficit financing by Central Bank	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
iv) Gross exchange reserves	1.4	2.2	2.0	2.6	3.2	3.8	3.7	4.0
Secondary criteria								
i) Tax revenue/GDP	18.4	20.1	19.5	20.3	21.0	23.0	22.8	23.9
ii) Wage bill /Tax revenue	50.6	48.3	60.6	58.6	57.6	50.4	47.8	42.7
iii) Internal investments/ Tax revenue	8.7	4.8	5.2	5.4	10.2	10.2	7.4	8.1
iv) Real Interest Rate	3.7	4.9	8.5	6.0	3.6	3.6	5.1	4.5
v) Real exchange rate stability	3.5	2.6	1.8	-3.0	-2.5	1.7	0.8	-0.8
Number of criteria met	4	5	4	5	5	4	5	4

Source: IMF data; estimates (*) and projections (**).

3 Prospects for 2008

Cape Verde's economic prospects are good. Growth would be sustained in the coming years through macroeconomic and structural measures set forth in the 2006 – 2010 national plan, the Economic Policy Support Facility of the IMF for 2006 -09 as well the medium term expenditure framework (CDMT) 2008-2010. Annual average inflation rate fell to 4.5% in 2007 against 6% in 2006 and it would be below 3% in 2008. The short term monetary policy aims to maintain macroeconomic stability and strengthen the tax system in order to boost public investments. The Short Term Expenditure Framework for 2008 -2010 has been validated. It is also worth noting that since December 2007, after seven years of negotiations, Cape Verde has become the 152nd member of the World Trade Organization (WTO). For its industrial goods, the country accepted bounded tariffs ranging from 0 to 55%. This implies gradual reductions until 2018, raising the highest rate to 15% on the average. With regard to agricultural products from Cape Verde, they will be subjected to an average tariff rate of about 19%. The country has also made some commitments to facilitate access to six segments of the services sector and a wide range of other sub sectors.

4 Conclusion and Recommendations

On the whole, Cape Verde's GDP volume continue to grow at pace above the average rate in Sub Saharan Africa. Since 2004, a challenging year for agriculture in the archipelago, this growth has been sustained to a large extent by a sound political environment. In 2008 and 2009, GDP volume would still grow by 7.6 and 7% respectively. Besides, since December 2007, Cape Verde has ceased to be a Least Developed Country (LDC) according to information contained in the Economic Prospects for Africa.

However despite, this impressive progress, the Country is still facing serious structural problems that must be taken into account in redistributing growth. These include massive employment, mostly structural, (183% in 2006), persistent relatively high levels of poverty, poor quality services provided by private and public companies, shortage of skilled labour and inadequate infrastructure. The geographical situation of Cape Verde (over ten islands and eight islets) must be taken into account in the country's development policy.

Other recommendations on other less structural aspects must be taken on board. These are to:

1) Modernize fishing which is one of the country's main exports as traditional methods are still be used. There is also the need to pay more attention to scarcity of potable water on the volcanic archipelago, desalinization of sea water, a costly procedure, would play a more important role.

2) Diversify tourist sites and develop policies that would help spread the effects of tourism at the local level as the activity is only concentrated on some major sites and products consumed by tourist are mostly imported and local markets derive very little benefits.