Ministério
das Finanças
Gabinete do Ministro das Finanças

Ms. Kristalina Ivanova Georgieva-Kinova
Interim President of the World Bank Group
WASHINGTON, DC

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Praia, April 2nd, 2019

Subject: Letter of Development Policy

Dear Ms. President,

1. This development policy letter presents the reforms being implemented by the Government of Cabo Verde to reduce fiscal risks and enhance fiscal management in support of sustainable private-sector led growth. The letter also highlights reforms to strengthen the institutional and legal framework to increase disaster and climate resilience, as well as incorporating disaster and climate resilience considerations into the management of critical infrastructure and territorial planning.

2. The government of Cabo Verde is strongly committed to boosting private sector led growth and tackling the high ratio of public debt over Gross Domestic Product by implementing critical structural reforms. To that end, the Government will need sustained funding support from its strategic partners while it continues to implement its strategy to be less dependent on the development partners financial support. This Fiscal Management and Growth Development Policy Financing (DPF) series and the Disaster Risk Management Development Policy Credit and Loan with a Cat DDO are fully aligned with the objectives of Sustainable Development Strategic Plan (PEDS). The DPF supports government reforms to reduce fiscal risks in key State-Owned Enterprises (SOEs), while boosting private-sector led provision of infrastructure services. The DPF also supports government efforts to strengthen efficiency, accountability and transparency in fiscal management. This will support government's efforts for fiscal consolidation and enhanced fiscal sustainability.

3. The letter focuses on the following aspects: (i) the PEDS; (ii) the economic context and outlook; and (iii) the reform agenda under implementation by the Government.

I. PEDS - Sustainable Development Strategic Plan

4. The PEDS sets challenging targets for the 2017/2021 period, using a consistent long-term approach that is based on four structural objectives: (i) making Cabo Verde a MidAtlantic circulation economy; (ii) guaranteeing Economic & Environmental Sustainability; (iii) assuring social inclusion and reducing inequalities and asymmetries; and (iv) reinforcing sovereignty, valuing democracy and guiding diplomacy towards the country's development challenges.

5. The PEDS, in defining as an objective "making Cabo Verde a Mid-Atlantic circulation economy", responds to the imperative to be part of the World Economic System (SEM) by focusing on the political, institutional and social stability of the country so as to capitalize on the on the country's geo-strategic location. Cabo Verde is a country with a strategic location for efficient and potentially cost efficient connections between Africa, Europe and America, open to the world, cosmopolitan and safe with low political, social and health risks, with a strong focus on building a knowledge and innovation economy, to function as an air, maritime, digital and innovation, financial, commercial and industrial and investment platform for its greater contribution to the World Economic System

6. This additional contribution to the World Economy requires a positive attitude toward development and a belief by the citizens on the country's potential a predisposition to change the current state of affairs and build a shared future that benefits current generation while not undermining future generations. Transformative reforms are thus required. Reform requires clarity of purpose, strategy, intent, consistency, courage and good time management to make transformative changes to the institutional, economic and social environment needed to achieve the development objectives.

7. For an effective and efficient implementation of the PEDS, it requires : (i) a model of economic growth based on private investment, which foster debt sustainability, and brings about shared prosperity and on social and territorial inclusion; (ii) a major focus on local and regional development via greater decentralisation, mindful of sustainable development goals and with the State partnering with enterprises and with non-governmental organisations; (iii) a competent public administration focused on a mission of public service and guided by the supremacy of law; and (iv) political and governing action aimed at stimulating families' autonomy and self-sufficiency via employment, production and income generation and instruments that define clear objective and impartial rules for citizens' access to benefits and social and programmes.

8. The key performance indicators in the PEDS are ambitious: increasing the average income of Cabo Verdeans, reducing public debt, reducing the unemployment rate, significantly improving the Human Development Index, and reducing social inequalities and absolute poverty. We are confident we will achieve them.

II. Macroeconomic policy framework

9. During the period of 2010-2015, economic growth decelerated significantly to an average of 1.5 percent (compared to 7.6 percent in the 2004-2009 period), a result of the protracted impact of the global financial crisis. Countercyclical fiscal measures did not restore growth but instead led to a sharp increase in the stock of debt. GDP growth recovery started in 2016 and was consolidated in 2017, as information from the Institute of National Statistics shows GDP grew by 4.7 percent and 4 percent, respectively. Recent information for the 2018 indicates that the economy grew by 5,5 percent, with a strong increase in the fourth quarter of 2018 around 7.6 percent. Investors and consumers' confidence indicators are also positive and improving.

10. With inflation expectations low and limited pressure on the peg, monetary policy has been accommodative. The Central Bank will remain vigilant, adjusting policy as needed to ensure price stability while supporting growth.

11. On the fiscal front, this Government inherited a country in 2016 with the highest debt to GDP ratios and among the slowest growing on the continent. However, the fiscal strategy adopted by the current Government in focused in a medium term fiscal consolidation with the overall fiscal deficit decreasing from 4.6 percent of GDP in 2015 to 2.8 percent of GDP in 2018. We have been working to address the fiscal imbalance in a more holistic way. This includes: (i) implementation of a proactive fiscal consolidation strategy based notably on improved tax collection; (ii) enhanced public investment prioritization to ensure that selected projects are aligned with the PEDS and will yield the highest development impact; and (iii) strengthened legislative underpinnings for budget and debt management.

12. While public debt is high, debt service remains manageable due to the high level of concessionality of external debt. This was confirmed by the International Monetary Fund Article IV assessment. In fact, the sustainability of the debt was confirmed. Nevertheless, the Government is committed to further reducing the debt level and maintaining a decreasing debt trajectory. Recent estimation shows a reduction from 126 percent of GDP in 2015 to 122.8 percent of GDP in 2018 and the target is to achieve 100% by 2025 based on: (i) the sustained implementation of our ambitious SOEs divestiture program which will be instrumental to reduce net public sector financing needs while generating revenues from divestiture proceeds; and (ii) real GDP growth acceleration. The Government is also working on the new medium-term debt management strategy to better guide its annual borrowing in line with clearer targets.

III. Reforms agenda

Reducing fiscal risks arising from SOEs while unlocking binding constraints to accelerating growth and supporting private-sector led growth. The Government of Cabo Verde intends to foster private sector-led growth while consolidating public finances to reduce the deficit and debt levels. Our policy is to divest from State-Owned Enterprises (SOEs) as a mean to bring about increased competitiveness and service delivery, and reduced fiscal risks from SOE-related contingent liabilities. The Government believes that it is critical that key service providers in the economy be owned and managed by private operators, as they bring increased investment, technical and managerial know-how and a drive for better quality and performance. In addition, the divestiture from key sectors, will allow the operational, commercial and financial risks associated with the operations in these sectors to be shifted to the private operators, who are better equipped to turn around these enterprises into profit making entities. Furthermore, the divestiture program will help the Government reduce public debt by generating revenues from the sale of public assets, and bringing down SOE-related net financing needs for the general government, and reducing SOE debt.

13. To better monitor the SOEs, a Public Enterprise Reform Unit (UASE) was set up within the Ministry of Finance in 2016. UASE is the result of the merger of the SOEs Department, formerly housed in the Treasury Department, and the Privatization and Public, Private Partnership (PPP) unit. Its mission is to implement a wide ranging privatization program and enforce a rigorous oversight on SOEs, to not only ensure improved efficiency, but also mitigate the fiscal risks tied to these companies until they are divested from.

14. An action plan has been prepared for the divestiture of key SOEs. A list of 23 enterprises to be divested from or restructured has been approved by the Cabinet and published in the Official Gazette. The Government has also undertaken important measures to accelerate this process. In addition, we have undertaken prompt action on the SOEs posing the most critical risks to help foster growth and which can have a negative impact on debt sustainability.

15. First, the Government has taken decisive measures to mitigate fiscal risks arising from the national airline, TACV (now Cabo Verde Airlines - CVA). In preparation for privatization, CVA has been proactively restructured through [ongoing] substantial employee retrenchment, debt restructuring, and the development of new strategies to enhance its core business. CVA's domestic operations were discontinued as of August 1st, 2017 after establishing a partnership agreement with Binter, a Spanish carrier, to provide inter-island air transport services. Binter was selected considering its substantive experience in offering inter-islands services in the Canary Islands, where the overall flight conditions are quite similar to those of Cabo Verde. The State has no involvement in the domestic air transportation and does not provide any subsidy to the operator who has agreed to provide services to all islands. It is worth noting that for domestic air service transportation, the current operator does not have any exclusive right to be the sole operator. As such, any operator who wish to operate in Cape Verde simply needs to meet the requirements to be granted a certification by the regulatory agency.

With respect to the international operations, the Government entered in 2017 into a one-year management contract with Icelandair to get CVA ready for its privatization. In parallel to having a management contract while privatization was being prepared, the company has undergone a complete restructuring, as explained in paragraph 17. In addition, and as per Law Nº 47/IV/92 of July 6, the company was the object of a valuation and based on the terms set out, as per Decree Law Nº 45/2017 of September 21, 2017, the airline was offered to privatization.

16. The first phase of the privatization process of CVA is concluded,Loftleider Cabo Verde (a company owned 70% by Loftleidir Icelandic and 30% by investors) acquired 51 percent of CVA equity. As per Law Nº 47/IV/92 of July 6, 10% of the shares will be offered to the airline's employees and the diaspora. The Government will also proceed with the sale of the remaining 39 percent of the company in 2019.

17. In parallel, the retrenchment plan of CVA is being implemented and the ongoing debt restructuring process - a renegotiation process with the main creditors of the company - is concluded. In the context of the reform to CVA, the financial support to the entity from the Government budget will fully cease by this year – this support amounted to 2.5 percent of GDP in 2017. By selling 51% of the shares to a strategic partner the State as already reduced its operational and financial risk. The sale of the remaining 49% in 2019 will bring the State exposure to none.

18. The Government as concluded its plans to divest from the inter-island maritime transport sector to improve service delivery and promote private sector investment and growth. The transaction was concluded in January 2019 and the concession contract was signed in February with the company Transisular. SA & Transisular Lda. After a several negotiations between the Government, the company Transisular and the National Ship-owners, the parties have reached an agreement to increase from 25% to 49% the capital share reserved to the National Ship-owners in the new concessionaire company. Nine National Ship-owners have signed with the company Transisular the new concessionaire company subscription agreement. Between April and June the new concessionaire company will initiate the implementation of the new routes. From August to December, the new concessionaire company will bring a new vessel to Cabo Verde, as determined by the concession contract.

19. The Government has also moved swiftly to minimize fiscal risks associated with the construction, management and sale of social housing by the SOE Imobiliária, Fundiária e Habitat (IFH), under the Casa para Todos (CPT) program. We inherited a program whose financial

viability was not established and led to increasing demands on the Government budget. The Government took the decision to restructure the program to spin-off the social housing component of the program (Class A) to the municipalities, and market houses of classes B and C to the public. The municipalities will now be responsible for the management of Class A houses. The transfer process has already been finalized, and the municipalities are receiving all the necessary support to ensure that the program continues to be managed with discipline and that the transition occurs smoothly. In parallel, the new commercial plan for classes B and C houses has already shown positive results. As a result, IFH will be better positioned to comply with its medium-term financial obligations with the Portuguese Government (which is the originator of the credit line for the program Casa para Todos financed through the Caixa Geral de Dépositos Bank). In relation to these obligations, the Government also instructed IFH to open a separate dedicated bank account for collecting the proceeds of the sale of those units remaining with IFH (classes B and C) for enhanced transparency. Furthermore, to generate more proceeds from the sale of Class B and C houses, the Government will remove the current ceiling imposed on the sale prices.

20. As a Government, we have also taken the decision to address fiscal risks and service delivery issues in the energy sector, introducing reforms to improve the governance and weak financial position of the utility. The energy company (ELECTRA) has recently signed a performance-based management contract with clear targets, results indicators and incentives which will be reviewed annually. The salary of the management team is now linked to the achievement of these targets. UASE will monitor compliance. To reduce the cost of electricity, we are pursuing a three-pronged strategy involving (1) the implementation of a commercial loss-reduction plan, (2) technical loss reduction through grid rehabilitation investments, and (3) a switch from diesel-based power plants to heavy fuel oil-based generators. It is the commitment of this Government to lower commercial losses below 20 percent by 2020. In parallel, the tariff structure will be reviewed to ensure both affordability and financial sustainability. Moreover, the State will divest from ELECTRA. A study by an internationally renewed firm was carried out to prepare for the privatization and recommended that a management contract be signed. Now that this intermediary step has been completed, the Government is accelerating the pace for the divestiture as unsolicited expression of interest from potential buyers have been received. To that end, a valuation of ELECTRA has been completed. The task force team that is implementing the privatization process, is finalizing the process of hiring a Transaction Advisor that will help to implement the process of divestment. The process is expected to be concluded until the end of 2019.

21. The Government will continue to adopt institutional reforms and policy measures to stimulate private investment, both domestic and foreign. This strategy includes: (i) enhanced synergies between private and public investment; and (ii) export facilitation and investment promotion. This strategy will be complemented by the development of a suitable policy, legal and institutional framework for the implementation of privatization operations and PPPs approved by the Government. The Government is currently moving forward on this agenda by assessing the PPP pipeline, so that sound PPP transactions can be carried out to bring private investment and management in several sectors. Regarding investment promotion, the former investment promotion agency was transformed into an agency to foster both trade and investment, known as Cabo Verde Trade Invest (CVTI). Furthermore, CVTI has developed an investor's after care system, which will allow to provide additional hands on support to investors after the investment is made. In fact, the day to day operations of CVTI now emphasizes providing support to investors through the after care.

22. Finally, the Government is currently working with development partners on improving the investment climate, facilitating access to finance for MSME firms, and increasing the productivity and the competitiveness of the economy. In that sense, two important projects, Access to Finance for the MSME and the SOE's Reform project were approved by the WB and their implementation are key for the reform agenda of the Government.

Strengthen efficiency, accountability and transparency in fiscal management

23. The main feature of our policy regarding the public administration is the realization of a two-prong paradigm shift which entails (i) establishing a public administration underpinned by a culture of excellence and (ii) transforming the public administration into a set of agencies which support enterprises and tax payers in their day-to-day activity. In parallel, we are committed to enhancing the legal and institutional frameworks governing public financial and debt management for enhanced efficiency, accountability and transparency in the use of scarce resources.

24. Following the Public Expenditure and Financial Accountability (PEFA) exercise that was concluded in 2016, the Government has elaborated its new public reform agenda that will continue to be implemented in the next few years. Making public management (including, planning, budgeting, debt management, and tax administration) more effective are the priorities. On the legislative front, a new Organic Budget Law and a new Debt Law were recently approved by the Council of Ministers. The Debt Law was also approved by Parliament. A Court of Auditors Law was also approved by the Parliament last year, reinforcing transparency in the access to public accounts and information on budget execution.

25. In addition, the Government has made considerable progress to meet the global tax transparency standards and joined the Global Forum on Tax Transparency in July 2018. This highlights the country's commitment to increase tax transparency and ensure exchange of tax information with our counterparts. This administration is also exploring options to enhance the efficiency of tax expenditures, including plans to adopt a tax model for tax exemptions and revoke and/or eliminate unjustified tax incentives and exemptions. The authorities will be able to more systematically review tax expenditures and plan to streamline the regime starting with the 2020 budget law.

26. Finally, we are undertaking measures to increase efficiency of public investment by reinforcing our current public investment management system (PIMS). As we are committed to enforce the 2014 Planning Law and 2018 budget decree law, we have recently started implementing new PIM tools for improved selection and execution of public investment projects. All new projects must now be incorporated in the PIMS and must be selected according to more rigorous criteria, starting with the 2019 budget. This will help us to monitor the size and quality of our public investment budget by (i) linking more systematically sectoral projects to national investment priorities; (ii) assessing project financial costs; and (iii) ensuring that projects comply with technical standards. The new PIMS will significantly support our efforts to sustain fiscal and debt sustainability.

27. We have worked over the past two years to lay the ground to firmly advance towards a balance budget over the medium-term. Consistent with the new pieces of the legislation described above, the Government intends to issue in 2019 a revised MTFF for 2019-2021 reflecting fiscal and public debt medium-term targets that are consistent with sustained fiscal

consolidation and declining public debt/GDP ratios. We are committed to reduce the overall fiscal deficit by the next years, below the 3% of GDP.

Disaster and Climate Risk Management Reforms

28. Geological and climate-related disasters pose major challenges for sustainability of growth and resilient development of Cabo Verde. As a Small Island Developing State (SIDS) the country is highly exposed to the potential negative impacts of climate change. Recognizing this, the government is adopting the National Disaster Risk Reduction Strategy 2017-2030 (Estratégia Nacional de Redução de Riscos de Desastres - ENRRD), in order to effectively manage and reduce disaster and climate-related risks. Up until now, the Government has mainly focused its efforts on emergency preparedness and response. Recent adverse natural events have prompted the Government to have a more proactive and transversal approach to mainstream disaster and climate-related risk management considerations in development planning. With this objective, the National Civil Protection Agency and Firefighters (Serviço Nacional de Proteção Civil e Bombeiros — SNPCB) led the Government efforts of developing the ENRRD in consultation with a wide range of stakeholders and sectors. The overall objective is to establish an effective framework for managing disaster and climate-related risks, minimizing losses associated with natural catastrophes and avoiding the creation of new risks.

29. In the ENRRD, the Government proposes to create a National System for Disaster Risk Management (SINAGERD) to establish effective institutional arrangements, planning tools, information systems and coordination mechanisms with well-defined roles, responsibilities and capabilities and supported by appropriate financing mechanisms and instruments. Under the SINAGERD, the National Council for Disaster Risk Management composed of sectoral and line ministries and agencies that will be established to coordinate the integration of DRM into sectoral programs across the ministries and promote inter-sectoral coordination and policy oversight. A Special Office for Disaster Risk Management will be created within the Ministry of Internal Administration (MAI) to coordinate the implementation of the strategy and serve as Secretariat to the Council. This will be complemented by the re-launch of the multi-stakeholder National Platform for Disaster Risk Reduction, which will involve the Government, private sector, civil society and development partners.

30. The ENRRD includes a comprehensive set of reforms to reduce disaster risk. To ensure capacity for implementation and sustainability of the reforms, the ENRRD proposes several financial mechanisms such as including a line for DRR in the annual budget or integrating the reforms under the sectoral programs of the PEDS—for which financing is secured annually in the budget. The new strategy will encourage more effective disaster risk management, at the national and sub-national levels, as well as, across sectors. The number of sectors and municipalities incorporating DRR into their strategic development plans will be tracked and used as an indicator of progress in the implementation of this agenda. In addition, to measure the impact of these reforms at the local level, the number of municipal development plans incorporating disaster and climate-related risk management considerations including specific actions will be tracked.

31. We are mainstreaming DRR in priority sectors. The Ministry of Education is working with technical assistance from the WB to incorporate disaster and climate resilience considerations in the 2016 National Plan for the Rehabilitation of School Infrastructure. The main objective of the Plan is to rehabilitate, strengthen and expand school infrastructure in the country by 2021integrating climate and disaster risk considerations.

32. The country's dense road network is vulnerable to a range of disaster risks including volcanic eruptions, flash floods and landslides, and there is a significant emergency works backlog caused by such events. In line with an ongoing World Bank Transport project, the Government is rehabilitating and upgrading of the transport network, including strengthening the maintenance, rehabilitation and emergency repair of the road networks, due to disasters and climate change. A road maintenance fund has been established to manage road assets in the country and the government wishes to strengthen this further to address disaster risk management considerations. Construction standards and guidelines are also being reviewed to improve integrate disaster resilience considerations into the overall management of public school infrastructure.

33. This Government is advancing reforms to territorial planning, coastal management and open data. We inherited a fragmented land management system where existing land-use instruments do not appropriately integrate and enforce disaster and climate-related risk considerations. The Maritime and Ports Authority (Agência Marítima e Portuária - AMP) has authority 80 meters inland from high water, while the National Institute for Territorial Planning (Instituto Nacional de Gestão do Território — INGT) is responsible for territorial planning, urban development and land use policies in the rest of the territory. For simplification, we have decided to transfer the territorial planning mandate of all lands (including coastal land) to INGT and establishing a new legal framework for territorial planning in the country.

34. The Government has implemented a set of policy reforms that will strengthen urban and land-use planning by streamlining and systematizing regulations. Part of this reform will ensure that disaster and climate-related risk considerations will be incorporated into updated territorial and urban planning instruments at the national and sub-national levels. The National Directive for Territorial Planning (Directiva Nacional de Ordenamento do Território — DNOT) will be reformed, including directives and guidelines for managing disaster risk for territorial planning at the national level. The Regional Scheme for Territorial Planning (Esquema Regional de Ordenamento do Território — EROT), the Municipal Master Plan (Plano Diretor Municipal — PDM), and the Detailed Plan (Plano Detalhado — PD), which govern territorial planning, will also be reformed, to include local disaster risk assessments to inform the territorial planning process.

35. Integrating DRM considerations in the territorial planning instruments will require reliable and detailed sociodemographic and disaster risk information, which builds on (i) the National Institute of Statistics (Instituto Nacional de Estatística — INE) efforts to strengthen the framework to update of Open Data standards, protocols and procedures. Main modifications to the legislation are (i) giving the SEN the capacity to disclose anonymized data—private data without personally identifiable information—at the statistical unit level upon request; (ii) including among the SEN's objectives to collect the statistical information available across different public institutions; (iii) including the National Data Protection Commission in the National Statistical Council (governing body of the SEN); and (iv) allowing the Government to create a National Fund for Statistical Development (Fundo Nacional para Desenvolvimento de Estatística) as a special financing source for the SEN to ensure the production of high-quality official statistics. Enforcing Open Data standards will directly contribute to (i) the understanding of risk, through better identification of Cabo Verdean communities highly vulnerable to a natural catastrophe; (ii) informing the design and targeting of DRM and CCA interventions; and (iii) the monitoring and evaluation of the impact of these policies on the population.

36. We are striving to reduce the fiscal impact of disaster and climate-related risks. In order to manage operational and fiscal risks—including those from disasters—in a pro-active and

comprehensive manner, the MoF has established a Risk Management Service in the Treasury Department of the MoF. The mandate of this new service is to identify and manage all risks that could negatively affect MoF systems and operations, as well as any risks that could negatively affect fiscal outcomes, including those related to potential disaster and climate-related risks. In relation contingent liabilities related to disaster and climate-related risks more specifically, the mandate of the unit will be to (i) quantify the socioeconomic and financial impacts of disasters, in particular through the impact of disaster on public and private assets; (ii) develop a sovereign disaster risk financing strategy to manage disaster and climate-related contingent liabilities; and (iii) oversee the implementation of the strategy.

37. In this line, the Government has decided to establish a new contingency fund for disaster and emergency response. This newly established fund will be financed through an annual budget allocation, ensuring predictability of inflows. The by-laws creating the fund, establish the rules for determining annual budget allocations to the emergency fund; rules for prioritizing funding sources to finance disaster response, including contingent credit—and thus the Cat DDO; potential beneficiaries of the fund; rules for accessing fund resources; rules for reporting on, and accounting for executed fund resources; and auditing requirements. The new disaster contingency fund, in combination with the Cat DDO, represents a significant step toward strengthening Cabo Verde's fiscal resilience against disasters and climate-related events.

Conclusion

38. In light of the above, Ms. President, the World Bank Group's Fiscal Management and Growth DPF and CAT DDO operation are important in consolidating the gains of our previous reforms. They also support sustained economic growth by improving the impact of our current agenda of structural reforms, by reinforcing the competitiveness of our economy and the efficacy of investments, and by supporting the promotion of private sector development.

39. Therefore, on behalf of the Government of Cabo Verde, I hereby request a DPF operation in the amount of US$40 million and a Cat DDO operation in the amount of US$10 million (US$5 million equivalent IDA and US$5 million IBRD) for this calendar year. The operations will support the implementation of the PEDS 2017/2021, particularly the program of reforms included in the Government's Program for the medium term. The Cat DDO will also provide immediate liquidity to the Government in the event of a natural catastrophe.

40. I would like to reiterate our commitment to further strengthening the cooperation between the World Bank Group and the Government of Cabo Verde and we look forward to your continuous support to the Cabo Verde's development process.

Please accept, Ms. President, the assurance of my highest consideration.

Olavo Correia
Deputy Prime Minister and Minister of Finance

Cc: Mr. Jean-Claude Tchatchouang, Executive Director for Cabo Verde – World Bank

Mr. Gilberto Barros, Secretary of State of Finance – Ministry of Finance of Cabo Verde

Ms. Carla Cruz, National Director of Planning – Ministry of Finance