

**DEMOCRATIC REPUBLIC OF SÃO TOMÉ AND PRÍNCIPE: JOINT BANK-FUND DEBT
SUSTAINABILITY ANALYSIS ¹**

1. **The staffs' assessment of São Tomé and Príncipe's external debt outlook remains essentially unchanged since the latest World Bank Country Assistance Strategy (IDA/R2005-0087, May 2005) and IMF staff report (EBS/05/109, July 18, 2005).** The country faces a high risk of debt distress as the baseline scenario indicates a breach of debt thresholds prior to the production of oil expected to start in early the next decade (Box 1). Indeed, while the attainment of HIPC completion point and the implementation of sound macroeconomic policies will bring about an improvement in the country's debt outlook—particularly in terms of debt service due—São Tomé and Príncipe's external debt stock ratios will remain well above the policy-dependent debt burden thresholds until 2012-2013.² The debt stock ratios are highly vulnerable to exchange rate depreciations, a deceleration in export growth, and a reduction in foreign grants and FDI. External debt vulnerabilities (assessed in terms of NPV of debt-to-GDP and NPV of debt-to-revenue ratios) are expected to become more acute under a “no reform scenario,” characterized by a lack of fiscal adjustment during the projection period with respect to 2004. The Multilateral Debt Relief Initiative (MDRI), supported by sound macroeconomic policies, would further improve the country's debt indicators starting in 2006.

2. Background information on external debt developments is presented in section I. The evolution of debt since HIPC decision point is briefly discussed in section II. Sections III and IV present the staff's debt sustainability with respect to the relevant policy-dependent thresholds in a scenario that assumes the conduct of prudent macroeconomic policies and the attainment of HIPC completion point in mid-2006. Section V modifies the baseline scenario to include MDRI relief from the Fund and other IFIs. Section VI summarizes the main findings.

¹ This debt sustainability analysis for São Tomé and Príncipe was prepared under the Joint World Bank/IMF Debt Sustainability Framework for Low Income Countries of May 2005.

² São Tomé and Príncipe is currently classified as a “Poor Performer” according to the World Bank's Country Policy and Institutional Assessment (CPIA) index.

Box 1. São Tomé and Príncipe's Oil Prospects: An Approximation

- Preliminary staff estimates indicate that, even under the conservative assumption that only one out of the six blocks auctioned in the Joint Development Zone (JDZ) operated with Nigeria is found to be commercially exploitable, oil production would have a sizeable effect on São Tomé and Príncipe's economic prospects.
- The country's oil output share of 30 thousand barrels per day in the JDZ, at a constant price equivalent to US\$30 per barrel, would yield an average of US\$450 million in exports per year (equivalent to approximately 650 percent of the estimated 2006 GDP) for twenty years, and would require a total share of investment of US\$750 million in the country.
- Under this scenario, annual budget revenue from oil could stabilize at around US\$95 million over the long-term (equivalent to 135 percent of the estimated 2006 GDP), with the Permanent Fund for Future Generations reaching a steady-state level of US\$3.2 billion in constant 2006 dollar terms.
- The sensitivity analysis shows that oil price changes would not significantly change the staff's assessment about the sustainability of debt once oil production begins.

I. BACKGROUND

3. **São Tomé and Príncipe's medium- and long-term external debt is estimated at US\$316 million in nominal terms at end-2005, corresponding to a NPV of debt-to-export ratio of 500 percent.** The multilateral debt share of total debt is mostly owed to the World Bank and African Development Bank, while the share of official bilateral debt is about 40 percent, of which half is owed to France, Germany, Portugal, the Russian Federation, and Angola. São Tomé and Príncipe is current with its obligations with multilateral creditors and has cleared most of its arrears with Paris Club creditors as part of a new multilateral debt rescheduling agreement on Cologne terms (Box 2). The authorities are currently in the process of reconciling debt records with Paris Club creditors. Contacts with non-Paris Club bilateral creditors are also being pursued to start reconciliation of debt records.

4. **HIPC completion point is projected to be reached in mid-2006, provided that the PRGF-supported program has been satisfactorily implemented.** Progress toward reaching completion point objectives has been satisfactory so far, especially regarding the preparation of the first annual PRSP report, and meeting its health and education triggers. Satisfactory progress has also been made in improving governance and transparency.³

³ See floating completion point triggers in São Tomé and Príncipe HIPC Decision point Document (EBS/00/254, December 2000).

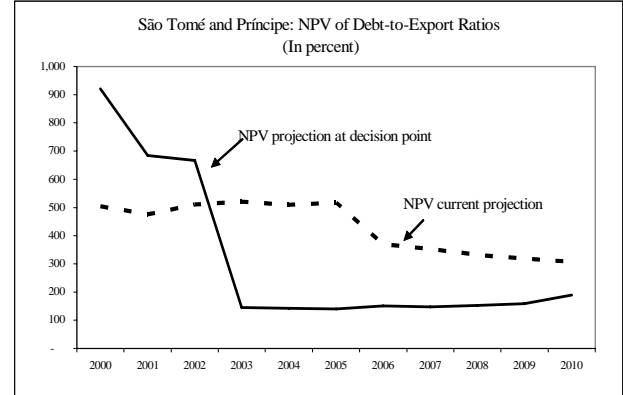
Box. 2. São Tomé and Príncipe: Paris Club Rescheduling

On September 13, 2005 Paris Club creditors agreed to provide São Tomé and Príncipe exceptional debt relief during the interim period of the HIPC Initiative. Regarding non-Official Development Assistance, the rescheduling agreement consists of a treatment under Cologne terms of the amounts due of principal and interest (excluding late interest) and not paid from May 1, 2001 to December 31, 2007. Debt repayments on Official Development Assistance (ODA) for the same period are rescheduled over a 40-year maturity with 16 years grace period. São Tomé and Príncipe commits to pay 100 percent of the amounts of principal due up to April 30, 2001 inclusive and not paid and of interest accrued up to the same date, inclusive and not paid.

The interim relief granted by Paris Club creditors will be credited towards total relief at the HIPC Initiative completion point. Regarding non-Paris Club creditors, São Tomé and Príncipe shall inform in writing to the Paris Club no later than April 1, 2006, of the progress made in its negotiations with these creditors; comparability of treatment of debt due would be paramount in this regard.

II. THE EVOLUTION OF DEBT SINCE HIPC DECISION POINT

5. **São Tomé and Príncipe reached decision point under the Enhanced HIPC Initiative in December 2000 (EBS/00254 of December 2000).** In that context, the NPV of debt-to-exports ratio was assumed to decline sharply from about 690 percent in 2001 to 143 percent in 2003 and remain at about that level during 2004-2008.



Source: EBS/00/254 and Fund staff projections.

6. **Latest staff estimates show significant differences vis-à-vis the levels of NPV of debt-to-exports ratios projected at HIPC decision point.** For example, as of end-2006, the

level of this ratio is more than twice its original projection. These discrepancies reflect the following factors:⁴

- A change in the methodology used to calculate the debt indicators from the HIPC DSA framework to the Low Income Countries DSA framework (DSF). These changes are reflected in the definition of exports, the discount rate used to calculate the NPV of debt and the exchange rates used to calculate the debt service projections.⁵
- HIPC completion point is currently assumed for mid-2006. By contrast, the decision point document assumed the attainment of HIPC completion point in 2003.
- Discount rates used to estimate NPV values in the current analysis are lower than those used in 2000.
- São Tomé and Príncipe's export performance since 2000 has been much weaker than expected.
- There has been some unanticipated new external borrowing, due to a more expansionary fiscal stance than originally envisaged.
- An unanticipated depreciation of the US dollar against the euro since 2000.

III. DEBT SUSTAINABILITY ANALYSIS

7. **The macroeconomic framework in the staff baseline scenario (Box 3)⁶ assumes a steady increase in economic activity over the medium-term, supported by sound macroeconomic policies and the development of the domestic oil sector.** Domestic

⁴ An estimation of the relative contribution of each of these factors to the increase in the NPV of debt-to-export ratios could not be done at this point as it would require a loan-by-loan reconciliation. Such an analysis will only be conducted in the context of the full-DSA exercise to be included in the HIPC completion point document.

⁵ The DSF uses same-year exports, as opposed to the 3-year backward average used for the decision point. Regarding the discount rates, the DSF methodology uses a fixed 5 percent rate compared to the currency-specific discount rates under the HIPC methodology. Finally, debt service is projected using WEO assumptions in the DSF, as opposed to fixed (end-1999) exchanges rates used for the decision point. See: "Debt Sustainability in Low-Income Countries: Proposal for an Operational Framework and Policy Implications", SM/04/27 and IDA/SecM2004-0035 and "Debt Sustainability in Low-Income Countries—Further Consideration on an Operational Framework and Policy Implications," SM/04/318 and IDA/SecM2004-0629/1.

⁶ The baseline scenario assumes the attainment of HIPC completion point by mid-2006.

investment would rise sharply from about 36 percent of GDP to an average of 54.7 percent of GDP in 2008-2010, largely on account of oil sector investment initiatives. The rise in the investment ratio will require a continuous reliance on foreign savings, although national savings are forecast to rise on account of an improved financial position of the government and increased private savings once stability and economic growth become firmly established. Key risks to the macro framework arise from a possible weakening of the fiscal consolidation effort in the wake of elections scheduled for 2006. Also, potential shortfalls in foreign assistance triggered by the future oil boom could exacerbate the government's budget constraint in the short-run.

Box. 3. São Tomé and Príncipe: Macroeconomic Assumptions in Baseline Scenario

Real GDP growth is projected to average 6 percent in 2005-2010 reflecting the implementation of the PRSP and continuous donors' support. The average growth rate is projected to increase to 8 percent in 2011-25 on account of increasing oil production.

Exports of goods and services are projected to increase at an average rate of 10 percent during 2005-2010 as a result of strong growth in tourism and a gradual recovery of cocoa export volumes. Oil exports explain the strong export performance projected for 2011-25.

The external current account deficit is expected to average 30 percent of GDP in 2005-2010; i.e., roughly unchanged with respect to recent years. The current account is projected to turn into a surplus of about 30 percent of GDP in 2011-25 due mainly to oil exports.

Fiscal projections assumes overall fiscal deficits declining from 18 percent of GDP on average in 2005-06 (excluding oil signature bonuses) to 6 percent in 2010, and a balanced budget thereafter, largely reflecting oil tax receipts.

Multilateral external loan financing is projected at an average of about US\$7.5 million per year during 2005-09, leveling off to US\$6 million in 2010-25.

8. **In the baseline scenario, São Tomé and Príncipe's debt outlook shows gradual improvements over the medium-term, but it will remain a source of vulnerability until oil production starts in 2012.** The NPV of public debt-to-GDP ratio falls from 153 percent in 2005 to 110 in 2006, and to 92 percent in 2010, reflecting a prudent public expenditure envelope underpinning the government's medium-term fiscal strategy (Table 1a).⁷ Only in 2012, the ratio falls significantly to 22 percent of GDP, due mainly to a large increase in GDP associated with the start in oil production. The NPV of debt-to-revenue ratio, at 278 percent in 2005 (Figure 1 and Table 1b), improves significantly in 2006 and remains around

⁷ All public debt is owed to foreign residents (i.e., external public debt).

160 percent during 2007-12, before declining gradually thereafter. The debt service-to-revenue ratio drops significantly following HIPC completion point in 2006 and remains sustainable thereafter.

9. **The debt dynamics are particularly vulnerable to shocks.** Sensitivity analysis indicates that under the most extreme stress test, defined as a 30 percent depreciation of the dobra exchange rate (measured in US dollar terms), the NPV of debt-to-GDP ratio increases to 186 percent in 2006, compared to about 110 percent in the baseline scenario (see Figure 1 and Table 1b). This reflects the fact that São Tomé and Príncipe's public debt is denominated in foreign currency. The scenario of no-fiscal-reform (defined to include an unchanged primary fiscal balance from its 2004 level, in terms of GDP) brings about an explosive debt burden, underlying the importance of fiscal consolidation to improve the external debt outlook.

IV. EXTERNAL DEBT SUSTAINABILITY

10. **The NPV of debt-to-exports ratio improves steadily in the baseline scenario, but will remain significantly above the policy-dependent thresholds until oil production starts.** The NPV of debt-to-export ratio decreases from 500 percent in 2005 to 315 percent in 2006, to 271 percent in 2010 (Table 2b). The ratio falls significantly below the 100 percent policy-dependent debt-burden threshold only in 2012, when oil production and exports are projected to begin. The debt service-to-exports ratio declines from 56 percent⁸ in 2005 to about 11 percent during 2007-10, before declining steadily during the following decade, reflecting the delivery of HIPC debt relief and the high concessionality in which new debt is contracted.

11. **Sensitivity analysis shows that the NPV of debt-to-exports ratio is particularly vulnerable to a deceleration in export growth.** Specifically, a decline in the export growth rate by one standard deviation from historical levels increases the ratio assessed at 300 percent under the baseline scenario to 424 percent in 2007 (Figure 2 and Table 2b).

V. THE EFFECTS OF MDRI

12. **The implementation of the MDRI would help reduce São Tomé and Príncipe's debt vulnerability (Figure 3, Table 3, and summary table below).** The MDRI would reduce the NPV of debt-to-exports ratio from 315 percent in the original baseline scenario to 176 percent in 2006, under the modified baseline; roughly 70 percent higher than the sustainable level in the case of a poor performing country. While NPV ratios would remain above the policy dependent thresholds, the debt service-to-exports ratio would be cut significantly during 2006-2010 under the MDRI resulting in substantial savings. The latter

⁸ In 2005, debt service refers to debt service due before HIPC completion point and excludes HIPC interim debt relief, rescheduling and cash payments on account of arrears.

reflects the relatively large share of debt to the World Bank and the African Development Bank in the country's total debt.

São Tomé and Príncipe: DSA Baseline and MDRI Scenarios 1/ (In percent)								
	Est.	Projections						
	2005	2006	2007	2008	2009	2012	2015	2025
NPV of debt-to-GDP ratio								
Before MDRI	153	110	106	102	97	22	7	10
After MDRI	...	61	62	61	60	14	5	7
NPV of debt-to-exports ratio								
Before MDRI	500	315	302	289	282	46	7	20
After MDRI	...	176	176	174	175	30	5	14
Debt service-to-export ratio 2/								
Before MDRI	56.0	19.1	12.4	11.4	10.6	2.4	0.4	2.1
After MDRI	...	9.9	6.7	6.5	6.0	1.8	0.3	1.3
Debt service-to-GDP ratio								
Before MDRI	17.1	6.7	4.4	4.0	3.6	1.2	0.4	1.1
After MDRI	...	3.5	2.4	2.3	2.1	0.8	0.3	0.7
Source: Staff projections and simulations.								
1/ Baseline assumes Paris Club rescheduling in 2005 and HIPC completion point by mid-2006.								
2/ Refers to exports of goods and nonfactor services.								

VI. CONCLUSION

13. **As noted in the latest World Bank Country Assistance Strategy (IDA/R2005-0087, May 2005) and IMF staff report (EBS/05/109, July 18, 2005), the country faces a high risk of debt distress until oil production starts early in the next decade.** Also, São Tomé and Príncipe's public debt will remain high and vulnerable to shocks to the exchange rate, exports and foreign grants, at least until oil production starts in 2012/13. Debt vulnerability would be further exacerbated in the absence of sound macroeconomic policies and undue delays with oil production. Calculations indicate that the country would benefit from a significant reduction in debt service under the MDRI starting 2006.