Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 19-Sep-2022 | Report No: PIDA34581

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Cabo Verde	P176148	Cabo Verde: Second Resilient and Equitable Recovery DPF with a Cat DDO (P176148)	P174754
Region	**Estimated Board Date**	**Practice Area (Lead)**	**Financing Instrument**
WESTERN AND CENTRAL AFRICA	17-Nov-2022	Macroeconomics, Trade and Investment	Development Policy Financing
Borrower(s)	**Implementing Agency**		
Cabo Verde	Ministry of Finance		

Proposed Development Objective(s)

The program development objective is to support the Government's efforts to strengthen the foundations for a resilient and equitable economic recovery through (i) reducing fiscal risks and improving debt transparency; (ii) strengthening the resilience of poor and vulnerable households to climate shocks; and (iii) enabling a sustainable private sector-led recovery.

Financing (in US$, Millions)

SUMMARY

Total Financing	52.50

DETAILS

Total World Bank Group Financing	52.50
World Bank Lending	52.50

Decision

The review did authorize the team to appraise and negotiate

B. Introduction and Context

Country Context

1. **The shock resulting from COVID-19 produced the largest economic contraction on record and exposed the country's economic vulnerabilities.** Prior to the crisis, Cabo Verde experienced robust and accelerating economic growth driven by a thriving tourism sector and benefiting from deep structural reforms, including reforms in the SOE sector, fiscal restraint, and debt reduction. The crisis reversed this progress, with Gross Domestic Product (GDP) contracting by 14.8 percent in 2020 (15.7 percent in per-capita terms), the second largest reduction in Sub-Saharan Africa (SSA). A comprehensive vaccination campaign in 2021 was fundamental for the recovery of the economy, despite several waves of the COVID-19 pandemic. Cabo Verde's number of administered vaccine doses was much higher than SSA averages, ranking 4th in SSA with 137.7 doses per 100 people. Supported by the gradual restarting of tourism from the second quarter, economic activity expanded by 7 percent in 2021, magnified by base effects.

2. **The Ukraine war exacerbated inflationary pressures and reduced growth prospects in 2022, affecting the poorest disproportionally through increasing food insecurity and malnutrition.** The main direct transmission channels are higher international oil and food prices. Because the country imports 80 percent of consumption products, there is a high transmission of international prices to domestic prices, affecting the poor disproportionally. The headline inflation rate in June 2022 stood at 8.2 percent (y/y). The annual inflation for food & beverage and energy was 16.2 and 31.8 percent, respectively. Around 20.4 percent of the population is predicted to have insufficient food consumption in 2022, according to the UN World Food Program. Malnutrition levels are believed to start deteriorating given the overreliance on food imports, the reduction of local agricultural production given the 4-years long drought, and the erosion of purchasing power. Authorities reacted swiftly in April 2022 with a policy package to protect the most vulnerable from the impact of the Ukraine war.

3. **The impact of the drought, the COVID-19 pandemic, and the Ukraine war exacerbated fiscal pressures, reversed the reduction in debt, and raised the urgency of reducing fiscal risks and enhancing debt transparency.** Starting in 2016, a successful fiscal consolidation program put public debt (as a share of GDP) on a declining path. The debt-to-GDP ratio declined from 128.4 percent in 2016, to 114 percent in 2019, but rose to 143 percent in 2021 due to the fallout from the COVID-19 crisis and is projected to reach 148 percent in 2022. The COVID-19 crisis also impacted the financial performance of an already weak SOE sector, requiring emergency fiscal support. Loan guarantees and capitalization in 2020 and 2021 amounted to US$112 million (6.4 percent of GDP). In July 2021, the authorities reversed the privatization of Cabo Verde, following the exceptionally negative impact of the pandemic on the aviation sector. However, the authorities remain committed to continuing to improve fiscal and debt management, with a view to lowering the debt burden and enhancing the provision of public services over the medium term.

4. **The macroeconomic policy framework is adequate for the proposed operation.** As a small open economy, the country remains vulnerable in the face of global uncertainty, particularly the COVID-19 crisis and the impact of the Ukraine war. However, the macroeconomic and structural policies being pursued by the authorities should support growth to gradually recover over the medium term. With the gradual resumption of tourism, capital flows, and economic activity, the economy is projected to grow 4 percent in 2022 and to be above potential in 2023-24. Over the medium term, the return to fiscal consolidation and key structural reforms, particularly in the SOE sector, will support growth. Further, monetary policy is expected to continue to be effective at supporting price stability and the exchange rate peg. The Government has a good track record and is committed to fiscal consolidation to return to fiscal sustainability. Although the risk of debt distress is high, public debt remains sustainable. International reserves are expected to remain at a comfortable level over the medium term.

Relationship to CPF

5. **The reform program supported by the DPF is consistent with the objectives of the Cabo Verde 2020 -2025 CPF.** The WBG CPF (report number 127164-CV), approved by the board in November 2019, builds on the findings of the Systemic Country Diagnostic produced in 2018. Pillar A supports the CPF's third objective supporting increased fiscal and macroeconomic resilience and manage the economic impact of climate shocks. Pillar B supports the CPF's second objective to overhaul social assistance, with a focus on productive inclusion. Finally, Pillar C also supports the CPF's third objective of improving the foundations for private sector growth. The proposed operation will advance reforms that meet the goals of the CPF, reinforcing the country's fiscal position as it seeks to return to a sustainable growth path and adjust its development model towards greater private sector participation.

C. Proposed Development Objective(s)

The program development objective is to support the Government's efforts to strengthen the foundations for a resilient and equitable economic recovery through (i) reducing fiscal risks and improving debt transparency; (ii) strengthening the resilience of poor and vulnerable households to climate shocks; and (iii) enabling a sustainable private sector-led recovery.

Key Results

6. The measures to strengthen the fiscal risk management framework proposed in pillar A are expected to reduce Cabo Verde's vulnerability to external shocks, thereby contributing to enhance fiscal sustainability in the medium term. The direct outcome of a strengthened management of fiscal risks associated to disasters will be the elaboration and further operationalization of a financial strategy against disasters and climate-related shocks. The reforms supported in pillar B to strengthen the shock-responsiveness of the safety net will increase the resilience of the most vulnerable households by better supporting them to cope with the impacts of climate shocks, including droughts, thereby contributing to the overall climate adaptation efforts of the Government. Additionally, it is expected that Cabo Verde will have a more shock-responsive social registry, strengthening its usability to respond to climate-related and other covariate shocks, including the impact of the Ukraine war. Finally, measures supported in pillar C to promote sustainable private sector investment in key sectors (electricity, tourism, and the blue economy) are expected to (i) reduce commercial losses, which will in turn lower the overall cost of electricity generation, improve energy efficiency and reduce GHG emissions, and strengthen energy independence; (ii) make the tourism sector more sustainable, resilient, and diversified across niches and islands, and better linked to the country's natural and cultural assets; and (iii) generate a more sustainable and resilient private investment into aquaculture.

D. Project Description

7. **The proposed hybrid operation is the second in a programmatic series of two single-tranche DPFs and is structured around three mutually reinforcing pillars:**

- **Pillar A improves debt transparency and reduces fiscal risks from SOEs and climate shocks.** The reform program includes measures to (i) strengthen SOE risk management, including quarterly fiscal risk assessment and the enhancement of the guarantees' legal framework; (ii) increase the frequency and quality of debt reporting, including publishing debt for the non-financial public sector; and (iii) strengthening the management of fiscal risks associated to disasters and climate-related risks.

- **Pillar B strengthens the resilience of poor and vulnerable households to shocks, particularly droughts.** This pillar builds on the COVID-19 response program and continues to strengthen the social protection system by (i) supporting the continued use of safety nets to respond to COVID-19 in the short-term, and further strengthening the shock-responsiveness to climate-related shocks of the safety net system in the medium-term; (ii) strengthening the usability of the social registry; and (iii) expanding the eligibility criteria of the National Emergency Fund to respond to droughts.

- **Pillar C supports a climate resilient and sustainable private sector-led recovery.** The reform program promotes socially and environmentally responsible investment by (i) supporting reforms in the electricity sector to attract private investment; (ii) promoting harmonized, streamlined, and more predictable regulations for a climate resilient tourism sector; and (iii) developing the regulatory framework of aquaculture.

8. **The DPF series is closely aligned with the Government's priorities established in the Strategic Plan for Sustainable Development (PEDS II), the Cabo Verde Ambition 2030, the National Disaster Risk Reduction Strategy (ENDRR), and the 2020 Nationally Determined Contribution (NDC).** The series complements other activities to address fiscal risks, including those associated with disaster and climate-related shocks, and debt transparency – notably through the Policy and Performance Actions (PPA) under the Sustainable Development Financing Framework (SDFP) and the first Cat DDO (P160628) and associated TA program closed in June 2022. Acknowledging the need to increase resilience to climate shocks to ensure the sustainability of the Cabo Verdean growth model, this operation includes a Catastrophic Drawdown Option (Cat DDO) with an associated Disaster Risk Management Program to support the authorities' efforts to strengthen the management of disaster and climate-related risks, reduce vulnerabilities to these risks in key economic sectors, and provide contingent financing to help in safeguarding fiscal consolidation efforts. The Cat DDO included in this operation ensures the continuity of the reform areas supported by the first Cat DDO.

9. **The World Bank has been working closely with main development partners leveraging its role in the six-member Budget Support Group (BSG), which includes the Luxembourg, Portugal, Spain, the EU, and the AfDB.** The BSG provides a framework for semi-annual joint reviews of the Government's development program. The joint missions enhance donor coordination and harmonization of DPF support for greater impact. The World Bank leads the technical discussion around the macroeconomic framework. The reform program supported by this DPF series was discussed with partners to ensure complementary in planned interventions, notably in the areas of macro and debt management, energy, social protection, and COVID-19 and Ukraine war policy responses. The World Bank has coordinated closely with the IMF during the series preparation, including through participation in decision meetings of both institutions, joint debt management missions, and joint discussion with government on policy priorities for returning to macro-fiscal sustainability and structural reforms in the aftermath of the crisis.

E. Implementation

Institutional and Implementation Arrangements

10. **M&E arrangements are led by the National Directorate of Planning (Direção Nacional de Planeamento, DNP) at the Ministry of Finance.** The World Bank team has been working in close collaboration with the Government and its

budget support partners to ensure adequate M&E of development interventions. The Government has invested substantially in developing an electronic platform for monitoring results of government spending. However, the system is currently only partially operational. A key weakness is inadequate data systems that should generate and update result information. The collection, quality control and sharing of administrative data across government agencies is problematic and household surveys are not designed to track the results of government programs. The new national strategy for the development of statistics and the revised law on statistics are designed to address key weaknesses and provide a strong foundation for improvement and sharing of survey and administrative data. The National Institute of Statistics will play a central role in coordinating the statistical system and in ensuring quality and independence of data systems and sharing these with users to respond to key monitoring and policy analysis demand. The team's assessment is that the country's M&E system is sufficiently robust for the purpose of this operation.

F. Poverty and Social Impacts, and Environmental, Forests, and Other Natural Resource Aspects

Poverty and Social Impacts

11. **The prior actions supported by this operation are expected to significantly contribute to avoiding surges in chronic poverty in the short term, protect mostly women-led households, and foster poverty reduction over the medium term.** The DPF focus on reducing fiscal risks and increasing debt transparency contributes to establishing an enabling environment for prudent fiscal management and sustained economic growth. An adequate management of fiscal risks will create fiscal space to scale up pro-poor spending and provide more resources to finance the shock-response safety net framework. Strengthening the resilience of the poor to economic shocks will contribute to prevent vulnerable households, particularly women-led, from falling into poverty due to systemic or idiosyncratic shocks. Enabling a private sector led and sustainable recovery is also expected to support sustainable growth and job creation, which will be beneficial for the poor over the medium-term.

Environmental, Forests, and Other Natural Resource Aspects

12. **Some of the reforms and policy actions supported by the proposed operation are expected to have a significant positive environmental impact on climate adaptation and mitigation and support Cabo Verde in implementing its NDC.** The establishment of a shock-response safety net framework (*Prior Action 4*) would raise the resilience of vulnerable households to climate-related shocks. Targeted drought response project investments funded through the FNE (*Prior Action 5*) would provide water management infrastructure such as irrigation canals and water tanks and ultimately improve water management capacities. The power sector reform plan (*Prior Action 7*) would improve operational efficiency of the utility and reduce electricity system losses, which would decline from 26.1 percent in 2020 to 25 percent in 2023 and reach 23 percent in 2024. This implies lower generation which, in power systems strongly relying on thermal generation such as Cabo Verde's, will result in reduced GHG emissions. Support to the effective implementation of the planning and regulation for sustainable tourism (*Prior Action 8*) would ensure environmental protection and sustainability while enhancing climate adaptation in line with the ENDRR. Finally, the regulatory framework for Aquaculture (*Prior Action 9*) will also contribute to climate adaptation, as recognized in the country's 2020 update NDC, noting that aquaculture will provide a buffer to mitigate the volatility that climate change could impose on marine fisheries.

13. **The Government's capacity for environmental management is adequate and will play a key role in maximizing the sustainability of the DFP reform program.** The regulatory framework for tourism investments supported by the

operation (*Prior Action 8*) might impact water demand (and availability), energy demand (and sourcing), and waste generation, among others. The decrees regulating licensing of tourism accommodations and service providers will ensure the use of the environmental management framework in the expansion of the tourism sector, while fostering a sustainable use of natural resources.

G. Risks and Mitigation

14. **The overall risk rating for the DPF series is substantial.** Macroeconomic risks are high and depend primarily on the surge of new COVID-19 variants, the Ukraine war, and disaster and climate-related shocks. Fiscal and debt sustainability may deteriorate with an increase in the duration or scope of the Ukraine war, which could intensify inflationary pressures in food and energy, thereby increasing food insecurity and leading to the extension of policy support to ameliorate its impact on the most vulnerable. In this scenario, the projected start of the fiscal consolidation process could be delayed. However, the authorities remain committed to continuing to improve fiscal and debt management and restructuring SOEs over the medium term. Institutional capacity risks are also high. The reforms undertaken by the Government may be politically sensitive. To mitigate these risks, significant technical support has already been provided by the World Bank and other partners to inform the reform agenda with strong involvement of the national counterparts. Risks related to the implementation capacity of sector strategies and policies are substantial. Cabo Verde has made important strides in raising the capacity of the public service. However, significant deficiencies exist in some areas. Achieving the objectives supported by this operation will require strict fiscal discipline and sustained implementation of complex reforms.

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APPROVAL

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