



CABO VERDE

SELECTED ISSUES

November 2016

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CABO VERDE

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Approved By
African Department

Prepared by Ulrich Jacoby, Ermal Hitaj, Jasmin Sin,
La-Bus Fah Jirasavetakul, and Luiz Felipe Almeida,

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DETERMINANTS OF PRIVATE SECTOR CREDIT GROWTH IN CABO VERDE¹

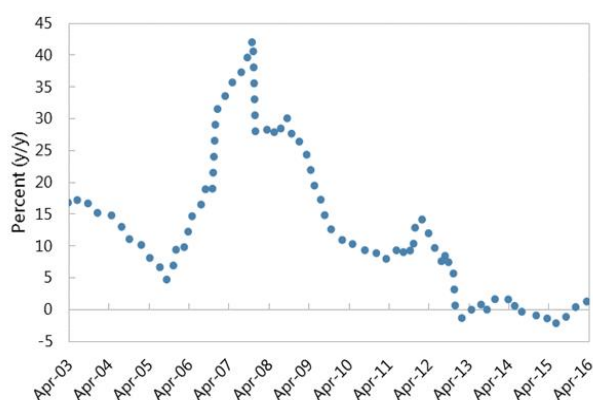
This note examines whether the recent slowdown in private sector credit growth is demand or supply driven. While in the late 2000s, demand factors have been the main drivers in Cabo Verde's credit market, supply dynamics' role has increased in recent years. For Cabo Verde to promote private sector-led growth and sustainable economic development, reforms aiming at strengthening both credit demand and supply will be essential. These include improving the business environment for the private sector as well as strengthening the financial sector by ensuring prudent banking supervision and an effective resolution of the non-performing loan (NPL) overhang.

A. Introduction

1. Growth of credit to the private sector in Cabo Verde has been declining recently

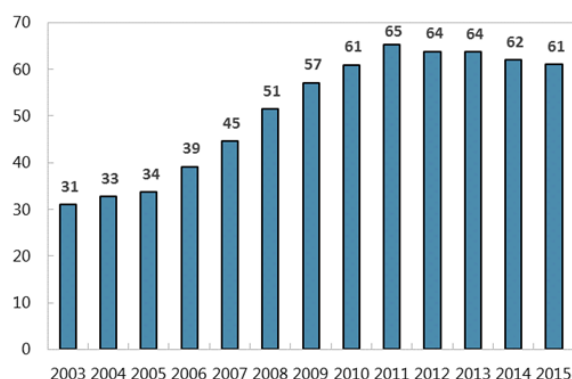
(Figures 1 and 2). Private sector credit growth was strong in the past, with an average of 18 percent for the 2000s, but it has been declining since late 2007, aggravated by the global financial and the euro crises. The growth of credit to the private sector peaked around 40 percent before the global financial crisis, and then declined to around 10 percent at end-2010. Credit growth has been close to zero since early 2013, and even turned negative in some months.

Figure 1. Private Sector Credit Growth



Source: Bank of Cabo Verde.

Figure 2. Private Sector Credit (Percent of Nominal GDP)



Source: Bank of Cabo Verde.

2. The recent slowdown in private sector credit growth has coincided with the

deceleration in economic growth. While tourism-related FDI was the main driver of economic growth over the decade and a half ending in 2007, Cabo Verde's economic growth in recent years

¹ This note was prepared by La-Bhus Fah Jirasavetakul and Jasmin Sin, with thanks to Luiz Almeida for excellent research assistance and to Ana Semedo and Suzy Brito (Banco de Cabo Verde) for providing the data.

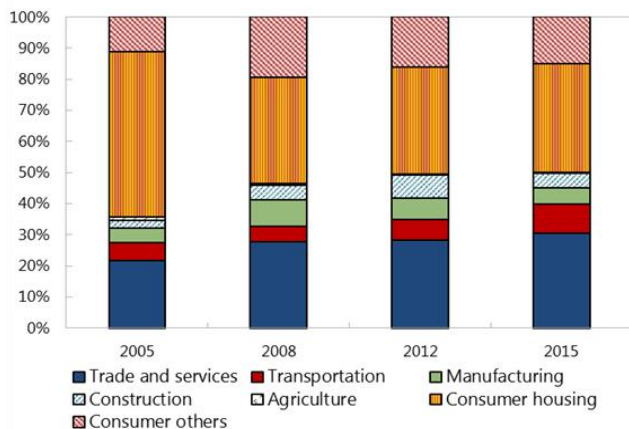
has been increasingly driven by public investment. As the public investment scaling-up winds down, private sector credit could be one of the factors that pull the country towards more sustainable private sector-led growth.

3. This analytical piece will examine the determinants of credit growth to the private sector in Cabo Verde, and draw policy implications. It will attempt to determine whether the recent stagnation of credit growth reflects weak demand by the private sector or reduced loan supply by banks.

B. Composition and Evolution of Private Sector Credit Aggregates

4. Over the last decade, business loans have increased their share in private sector credit, while the share of consumer loans has declined. The share of business loans in private sector credit rose from about 35 percent to 50 percent over the period 2005–15 (Figure 3). In 2015, trade and services constituted the largest share of business credit (about 60 percent), followed by transportation and manufacturing (19 and 11 percent, respectively). On the other hand, consumer loans are primarily made up of consumer housing credit, accounting for 70 percent of total consumer credit in 2015.

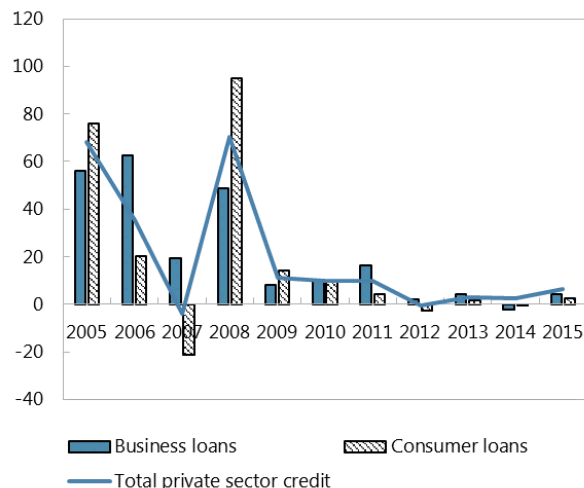
Figure 3. Composition of Credit to the Private Sector



Source: Bank of Cabo Verde.

Note: Manufacturing includes industry, extraction, and utility; Trade and services include tourism, commercial services and social services.

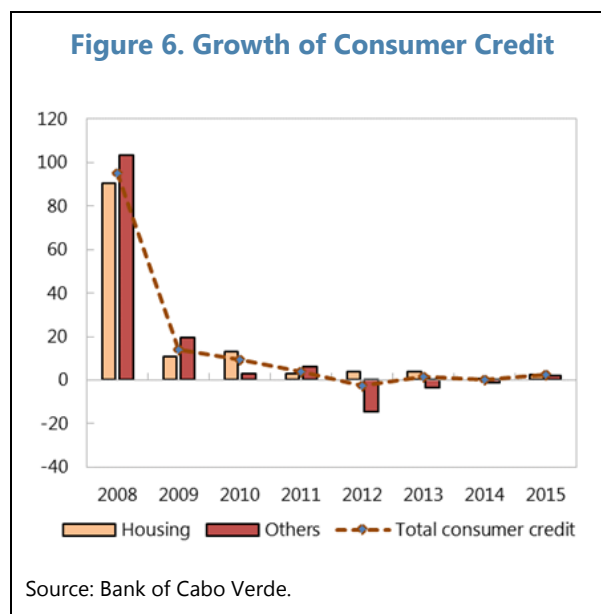
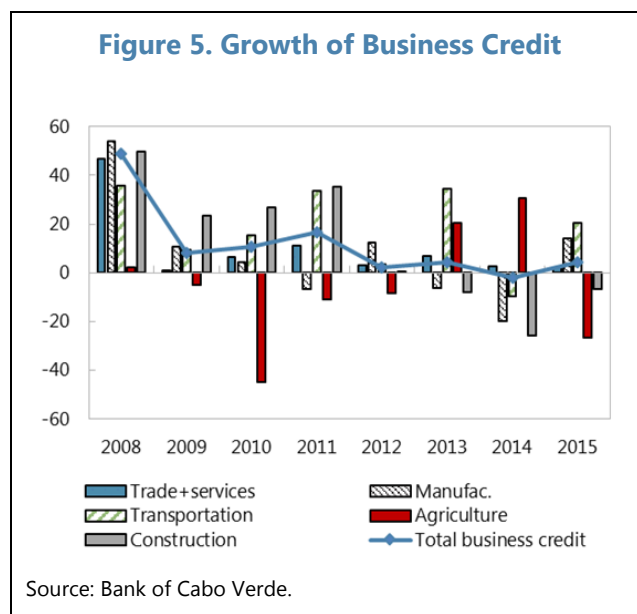
Figure 4. Growth of Credit to the Private Sector



Source: Bank of Cabo Verde.

5. The recent decline in private sector credit growth was driven by lower growth in both business and consumer credit (Figure 4). Lower business credit growth was primarily observed in the sectors of trade and services and construction. The growth of credit to the trade and services sector declined from an average of about 30 percent for the period 2001–08 to an average of

5 percent in the past five years (Figure 5), while that to the construction sector declined from a similar rate before the financial crisis to negative growth since 2013. Meanwhile, slow growth in consumer credit reflected declines in both housing credit and other consumer loans (Figure 6).

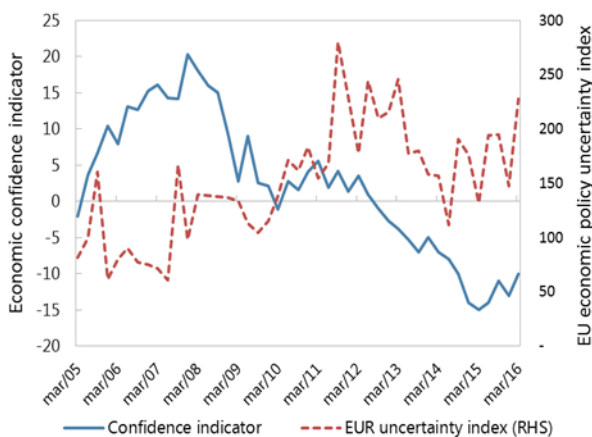


6. Several factors may have contributed to the slowdown in private sector credit growth.

On the demand side, a challenging external environment and uncertain investment prospects led to weak economic activity (Figure 7), slowing demand for credit. On the supply side, rising costs to banks, in particular from non-performing loans (NPLs), and squeezed profit margins reduced banks' ability to take on new credit risks (Figure 8). The impact of these factors has likely been exacerbated by banks' overall increased perception of risk, which has further reduced their willingness to lend.

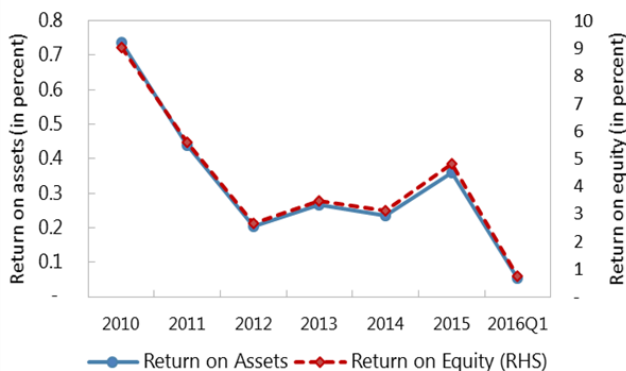
7. The ratio of non-performing loans (NPLs) to total private sector credit has increased substantially since the financial crisis (Figure 9). The most recent data for June 2016 (Figure 10) show that the majority of NPLs are recorded in the trade and services sector (43 percent of total NPLs or 22 percent of loans to that sector); consumer housing credit (22 percent of total NPLs or 11 percent of loans to that sector); other consumer credit (14 percent of total NPLs or 15 percent of loans to that sector); and transportation sector (10 percent of total NPLs or 18 percent of loans to that sector).

Figure 7. Investment Prospects and Uncertainty



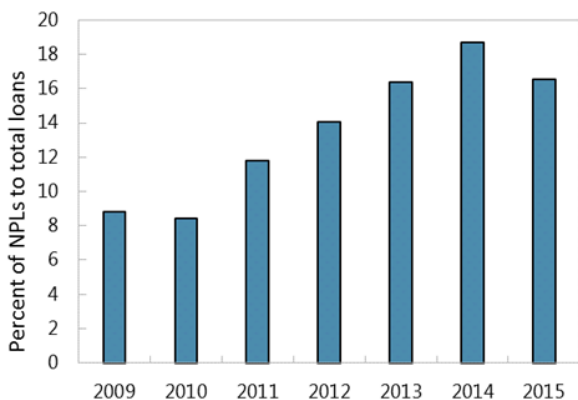
Source: INE, Baker et al. (2016)

Figure 8. Cabo Verdean Banks' Profitability



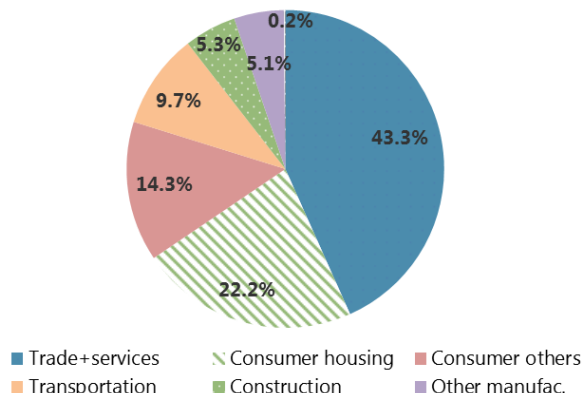
Source: Bank of Cabo Verde.

Figure 9. Non-Performing Loans to Total Loans



Source: Bank of Cabo Verde.

Figure 10. Composition of NPLs by Sector (June 2016)



Source: Bank of Cabo Verde.

C. Methodology: A Disequilibrium Approach

8. A disequilibrium model is adopted to study the relative importance of demand and supply factors in influencing private sector credit growth in Cabo Verde. The disequilibrium model, which was pioneered by Maddala and Nelson (1974) and first used in the context of credit by Laffont and Garcia (1977), has been adopted in the studies of credit stagnation in other developing countries.² The model allows for interest rate rigidity in the short run, and a disequilibrium occurs

² See for example, Ghosh and Ghosh (1999) for East Asia financial crisis countries; Barajas and Steiner (2002) for five Latin American countries; Allain and Oulidi (2009) for Morocco; and Poghosyan (2011) for Jordan.

when the credit market does not clear. At a disequilibrium, the amount of credit observed in the market would be the minimum of credit demand and credit supply, i.e.:

$$9. \quad C_t = \min(C_t^d, C_t^s)$$

where C_t is the actual amount of credit to the private sector (in real terms) at t , C_t^d is the (unobserved) credit demanded by the private sector and C_t^s is the (unobserved) credit supplied by banks. Excess supply exists when actual credit equals to credit demand, and vice versa.

9. Credit demand is modeled as a function of the cost of borrowing, deposit return, economic activity and policy uncertainty:

$$C_t^d = X_t^d \cdot \beta_d + u_t^d$$

where X_t^d is a vector of the following explanatory variables:

- *Cost of credit:* The cost of credit is represented by the real lending rate. Higher credit cost is expected to affect the demand for credit negatively.
- *Deposit return:* The real deposit return can be regarded as the opportunity cost of holding liquidity. A higher return on medium- and long-term deposits may increase credit demand, as firms prefer to hold less spare liquidity.
- *Economic activity:* Strong economic activity is likely to have a positive influence on economic prospects and investment decisions, hence stimulates credit demand. Given the lack of monthly GDP data for Cabo Verde, the four-month lag of tourism revenue is used.³
- *Policy uncertainty:* The close economic ties between Cabo Verde and the Eurozone means that policy uncertainty in Europe may affect Cabo Verde's economic outlook. An index of economic policy uncertainty for Europe (Baker et al, 2016) is therefore included in the credit demand function.

10. Credit supply is modeled as a function of credit return, lending capacity, premium over European rates, interest rate prospects and returns on alternative investment opportunities:

$$C_t^s = X_t^s \cdot \beta_s + u_t^s$$

where X_t^s is a vector of the following explanatory variables:

- *Return on credit:* This is represented by the real lending rate, which is also the cost of credit in the demand equation. Higher credit returns should increase banks' profitability and hence the quantity of credit supplied.

³ INE compiles monthly data on tourism statistics, which are published on a quarterly basis. Therefore, private investors and consumers are updated on tourism performance with a time lag.

- *Lending capacity:* Banks' capacity to lend is approximated by the stock of real deposits net of required reserves. At a given rate of return, banks are more likely to lend when more loanable funds are available.
- *Premium over European rates:* Because of the escudo's exchange rate peg to Euro, the differential between the policy rates set by BCV and ECB can be seen as a premium for lending in the domestic market. A higher policy rate differential may thus increase the credit supply by banks.
- *Interest rate prospects:* This is approximated by the movement of the EURIBOR, which reflects in part the expected future movements of interest rates in the Eurozone. A higher EURIBOR may increase interest rate expectations in Cabo Verde, hence increasing credit supply.
- *Opportunity cost:* To banks, the opportunity cost of lending is the return on other investments such as T-bills. A higher opportunity cost is expected to reduce the supply of credit.

11. The model coefficients are obtained by Maximum Likelihood (ML) Estimation, using monthly data for the period from December 2001 to December 2015.⁴ The ML method estimates the credit demand and supply equations by maximizing the following log-likelihood function: (Maddala and Nelson, 1974)

$$L = \sum_{t=1}^T \ln\{f_d(C_t) \cdot F^s(C_t) + f_s(C_t) \cdot F^d(C_t)\}$$

where f and F denote probability density and cumulative density functions, respectively, and the subscripts d and s denote demand and supply.⁵ The log-likelihood function builds on the idea that the observed credit equals to either credit demand or credit supply, whichever is minimum.

D. Estimation Results

12. The coefficients in the credit demand and supply functions are mostly significant and have the expected signs. Table 1 shows the ML estimation results. As expected, higher cost of credit reduces the amount of credit demanded, whereas a higher deposit return increases it. Economic activity—approximated by lagged tourism revenue—and policy uncertainty are, nevertheless, less significant in affecting credit demand. For the supply function, credit return, lending capacity, premium over European rates and interest rate prospects are found to have a positive influence on the amount of credit supplied. However, the opportunity cost of lending,

⁴ The small sample size somehow limits the number of variables that can be included in the credit demand and supply equations.

⁵ More specifically, $f_j(C_t) = \frac{1}{\sigma_j \sqrt{2\pi}} \cdot \exp\left\{-\frac{C_t^j - X_t^j \cdot \beta_j}{2\sigma_j^2}\right\}$ and $F_j(C_t) = \frac{1}{\sigma_j \sqrt{2\pi}} \cdot \int_{C_t}^{\infty} \exp\left\{-\frac{(C_t^j - X_t^j \cdot \beta_j)^2}{2\sigma_j^2}\right\} dC_t^j$, for $j = d$ and s . The

log-likelihood function assumes that the two error terms, u_t^d and u_t^s , are independently and normally distributed.

represented by the real T-bill rate, is not found to have a significant impact on banks' willingness to lend.

13. Applying the ML estimation results to the disequilibrium model, it reveals that excess demand and supply in Cabo Verde's credit market have increased over time. Figure 11 shows the amounts of credit demand and supply estimated by the disequilibrium model for the entire sample period from December 2001–December 2015, with the amount of actual credit included for comparison. In the first half of the 2000s, the credit market seems to have cleared relatively well. However, since then, credit market disequilibria have become more frequent.

14. While in the late 2000s, demand factors were the main drivers of credit growth, supply factors' influence has increased in recent years (Figures 11 and 12). For the period between the onset of the global financial crisis and 2010, excess supply appeared to be more prevalent in the credit market, suggesting that demand factors were the main drivers of credit growth during those years. Interestingly, since 2011, the credit market has undergone oscillating episodes of excess demand and supply, which coincides with the timing when credit growth slowed significantly. This finding suggests that both demand and supply factors have become equally important in affecting credit growth in Cabo Verde.

15. Accordingly, the recent slowdown of private sector credit growth in Cabo Verde is likely driven by both demand and supply factors. On the demand side, these factors may include subdued economic activity and a more complex and challenging external environment. On the supply side, factors causing slow growth of credit may include more cautious lending due to accumulated credit risk and low bank profitability, and the outlook of prolonged low interest rates.

Table 1. Maximum Likelihood Estimation of Disequilibrium Model

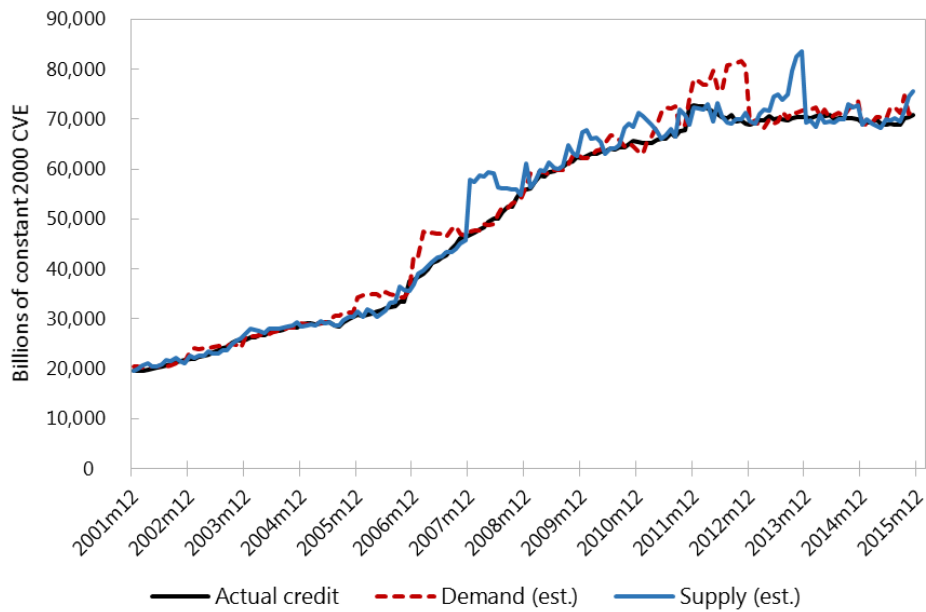
Credit demand:	Coefficient	S.E.
Real lending rate	-0.0576***	(0.0088)
Lagged tourism revenue (in logs)	-0.0103	(0.0247)
Real deposit rate	0.0535***	(0.0091)
EU economic policy uncertainty	-0.0000	(0.0001)
Constant	10.3551***	(0.1645)
Sigma	-4.1219***	(0.1533)
Year and quarter dummies	Y	
Credit supply:	Coefficient	S.E.
Real lending rate	0.0246***	(0.0056)
Real lending capacity (in logs)	0.8704***	(0.1701)
Differential between BCV and ECB policy rates	0.0139**	(0.0060)
Real T-bill rate	-0.0085	(0.0055)
Euribor	0.0686***	(0.0108)
Constant	0.3742	(1.7731)
Sigma	-3.9972***	(0.1116)
Year and quarter dummies	Y	
Number of observations		169
Log likelihood		449.68
St. dev. of demand equation error		0.0162
St. dev. of supply equation error		0.0184

Notes: Dependent variable is the logarithm of real credit to the private sector.

The optimization algorithm used is the Berndt, Hall, Hall, and Hausman (BHHH) method.

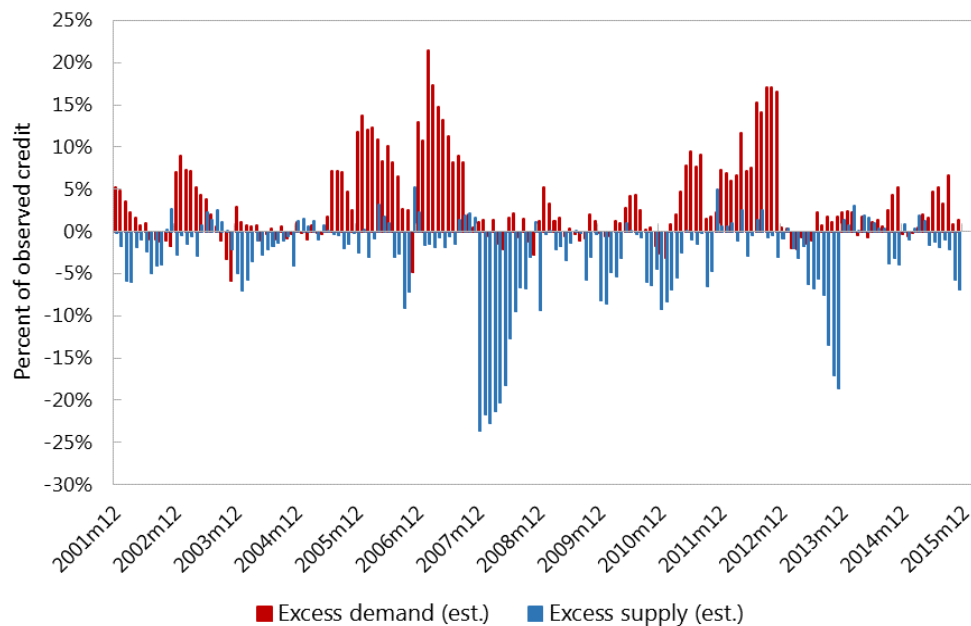
The standard errors are in parentheses. * p<0.1, ** p<0.05, *** p<0.01.

Figure 11. Estimated Credit Demand and Supply vs. Actual Credit



Source: IMF staff estimates.

Figure 12. Estimated Excess Demand and Supply of Credit



Source: IMF staff estimates.

16. There are, however, limitations of the disequilibrium model due to data unavailability. In the credit demand function, for example, tourism revenue is used as an indicator of economic

activity since monthly GDP data are not available. While tourism has been the engine for economic growth in Cabo Verde, tourism revenue fails to capture all business activities in other sectors. In addition, some supply-related factors, such as credit risk and banks' profitability, are not included due to limited data.⁶ Consequently, the elevated risk of lending associated with higher NPLs and lower bank profitability in the recent years may not be fully accounted for.

17. Moreover, there are factors outside the demand and supply equations that potentially also affect credit growth. One example is the quality of credit demand. Some of the credit demand comes from micro and small enterprises (MSEs). Banks are usually reluctant to lend to MSEs due to higher business risk associated with MSEs, asymmetric information, and the lack of collateral. Another example is the inactivity in Cabo Verde's interbank market. A more active interbank market could help reallocate liquidity across banks more efficiently and strengthen the transmission mechanism.

E. Conclusion

18. As the recent slowdown in private sector credit growth is likely driven by both demand and supply, reforms addressing both demand and supply obstacles will be essential. Policies that aim at tackling demand-side issues may include (i) increasing productivity by improving the business environment for the private sector, and (ii) providing financial and business literacy training to MSEs to improve the quality of loan proposals. Policies that focus on supply-side issues may include: (i) strengthening the financial sector by ensuring prudent banking supervision, (ii) reducing credit risks by resolving the NPL overhang, and (iii) facilitating the reallocation of liquidity across banks by developing the interbank market.

⁶ For example, financial soundness indicators (FSIs)—such as capital to risk-weighted assets, returns to assets, returns to equity, and non-performing loans—are only available at an annual level from 2002 to 2008 and at a quarterly level from 2009 onwards.

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BENCHMARKING CABO VERDE'S FINANCIAL SECTOR

The financial sector development in Cabo Verde is in line with what would be expected based on the country's economic and structural characteristics. The system enjoys relatively healthy depth, and access to banking is exceptionally good. However, the profitability of the banking sector remains low, the concentration high, and the sector could be overcrowded.

A. Introduction

- 1. The financial system in Cabo Verde has rapidly expanded over the past two decades, following the establishment of the Banco Comercial do Atlantico (BCA) and Banco Interatlantico (BI) in 1993 and 1998, respectively.** A single-bank country until 1993, by 2010 Cabo Verde had eight registered commercial banks, and by 2013 the number of bank branches had reached 113. Supported by the expansion of the financial system, credit to the private sector increased from 31 to 64 percent of GDP over 2002–13.
- 2. This note provides a comparative assessment of financial sector development in Cabo Verde by benchmarking it vis-à-vis countries with similar economic and structural characteristics.** The benchmarking exercise allows for an evaluation of a country's financial sector with regard to its depth, breadth, access and performance.
- 3. While a relative assessment, benchmarking does not entail a direct comparison.** Instead, it places financial sector assessment in the right economic and structural context, and helps identify areas for improvement and targets that are relevant to and appropriate for a country's development level.

B. Methodology

- 4. The benchmarks are estimated for each financial sector indicator through a quantile regression based on a country's economic and structural characteristics¹.** This helps gauge a country's expected financial sector development level in a policy-neutral environment. Subsequently, the difference between an indicator's observed value and the estimated benchmark could reflect healthy structural reforms (if positive) or scope for policy action (if negative).
- 5. Furthermore, comparisons are made with a few countries, namely Mauritius, The Bahamas, and Seychelles.** These are Small Island Countries with a higher income per capita than Cabo Verde. While the benchmarking exercise estimates the expected development of the financial sector, the peer comparison could serve to highlight differences between Cabo Verde and others that can serve as achievable examples.

¹ The dataset covers 203 countries over 40 years, and the explanatory variables include, among others, GDP per capita, population, age dependency ratios, and special circumstances, such as resource exports and presence of offshore financial centers.

C. Benchmarking

6. The financial sector indicators in Cabo Verde are broadly in line with what would be expected based on the country's economic and structural characteristics (Figures 1 and 2).

Depth and Breadth

7. Cabo Verde's financial sector is performing as expected with regards to depth parameters. Private sector credit to GDP is significantly above the SSA median and right at the expected median, whereas domestic bank deposits to GDP are even slightly above the median.

8. Breadth parameters send mixed signals vis-à-vis the benchmark. The asset concentration of the top 3 banks is at about the expected median. Bank credit to the public sector is, however, on the high side, reflecting good capacity to mobilize domestic savings to finance public spending. On the other hand, the decoupling from the SSA median starting in 2007 could also be a result of the counter-cyclical fiscal policy and weak private investment.

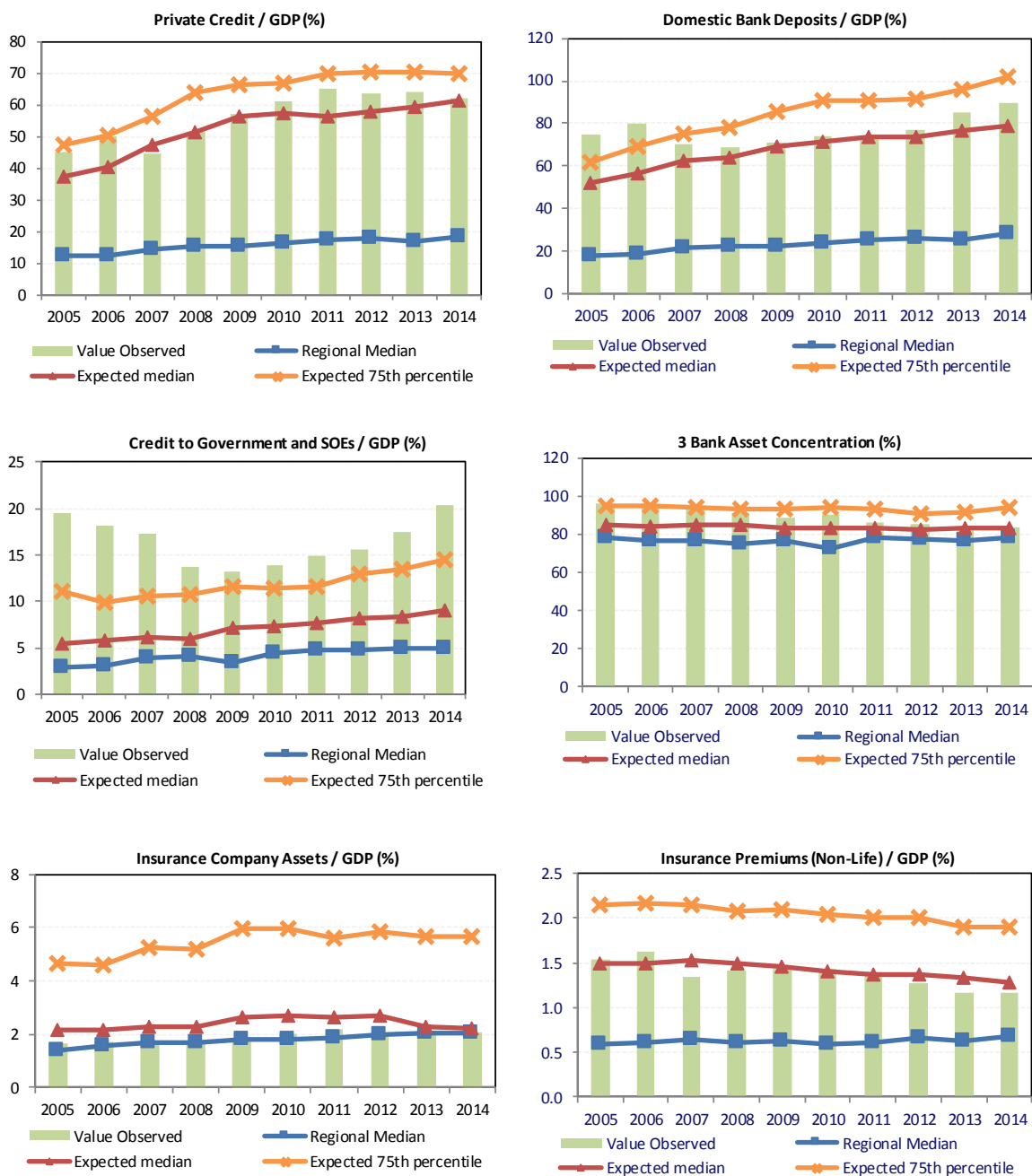
9. On the basis of available data, benchmark estimates for insurance company assets indicate that Cabo Verde is performing in line with expectations. On the other hand, the insurance premium to GDP ratio is slightly below the expected median.

Access and Profitability

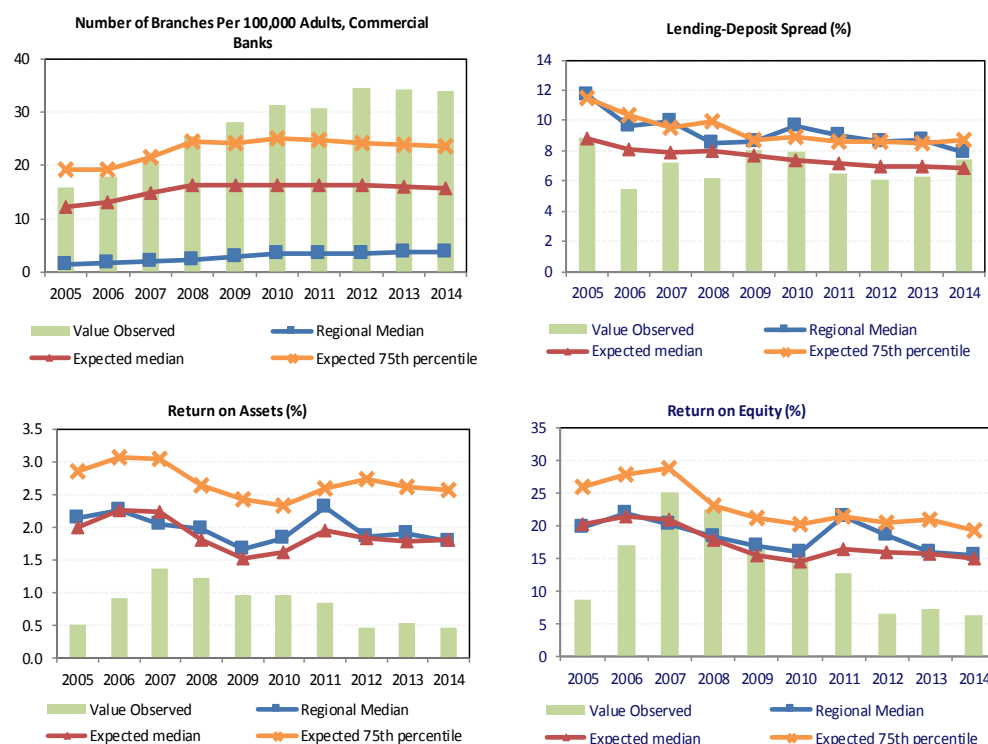
10. As reflected by the high number of bank branches per 100,000 adults, Cabo Verde is significantly above the expected median—and even above the expected 75 percentile—regarding access to the banking system.

11. However, the profitability indicators suggest that the country's banking sector is underperforming relative to expectations. The lending-deposit spread is in line with the expected median, but below the SSA median. On the other hand, return on assets and return on equity are both well below the expected median and the SSA median, likely impacted by significant shares of government bonds (with lower interest rate differential) in bank assets, and high NPLS.

Figure 1. Cabo Verde: Selected Indicators on Financial Sector Breadth and Depth



Source: FinStats Data.

Figure 2. Cabo Verde: Selected Indicators on Financial Sector Access and Performance

Source: FinStats Data.

Summary

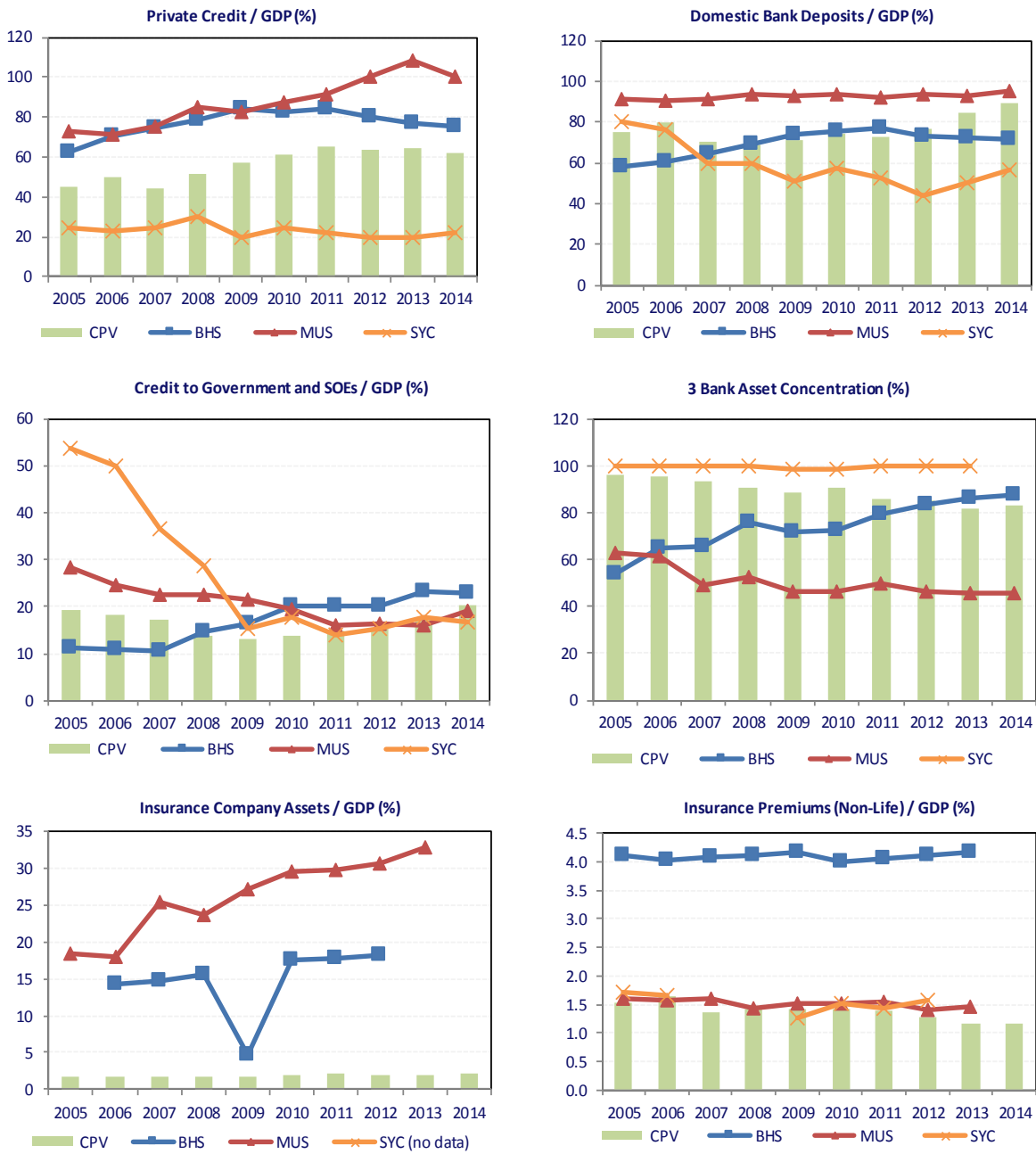
12. While the Cabo Verdean financial sector's performance is broadly in line with the estimated benchmarks, a few issues deserve attention:

- i. There is little financial sector activity outside of banking.
- ii. Although asset concentration is high, it is in line with the expected benchmarks. While there are eight banks that operate in the jurisdiction, the lending activity is firmly concentrated in the top three.
- iii. While the number of branches per 100,000 adults is high relative to expectations, profitability is rather low, with returns from assets and equity significantly below the expected median. Viewed together with the high asset concentration, this could suggest that the banking sector is overcrowded.

D. Peer Comparison

13. Although the benchmarking exercise shows that Cabo Verde's financial sector development is not lagging behind, a direct comparison with select peers shows that there is significant room for improvement, including the depth of the insurance sector (Figure 3).

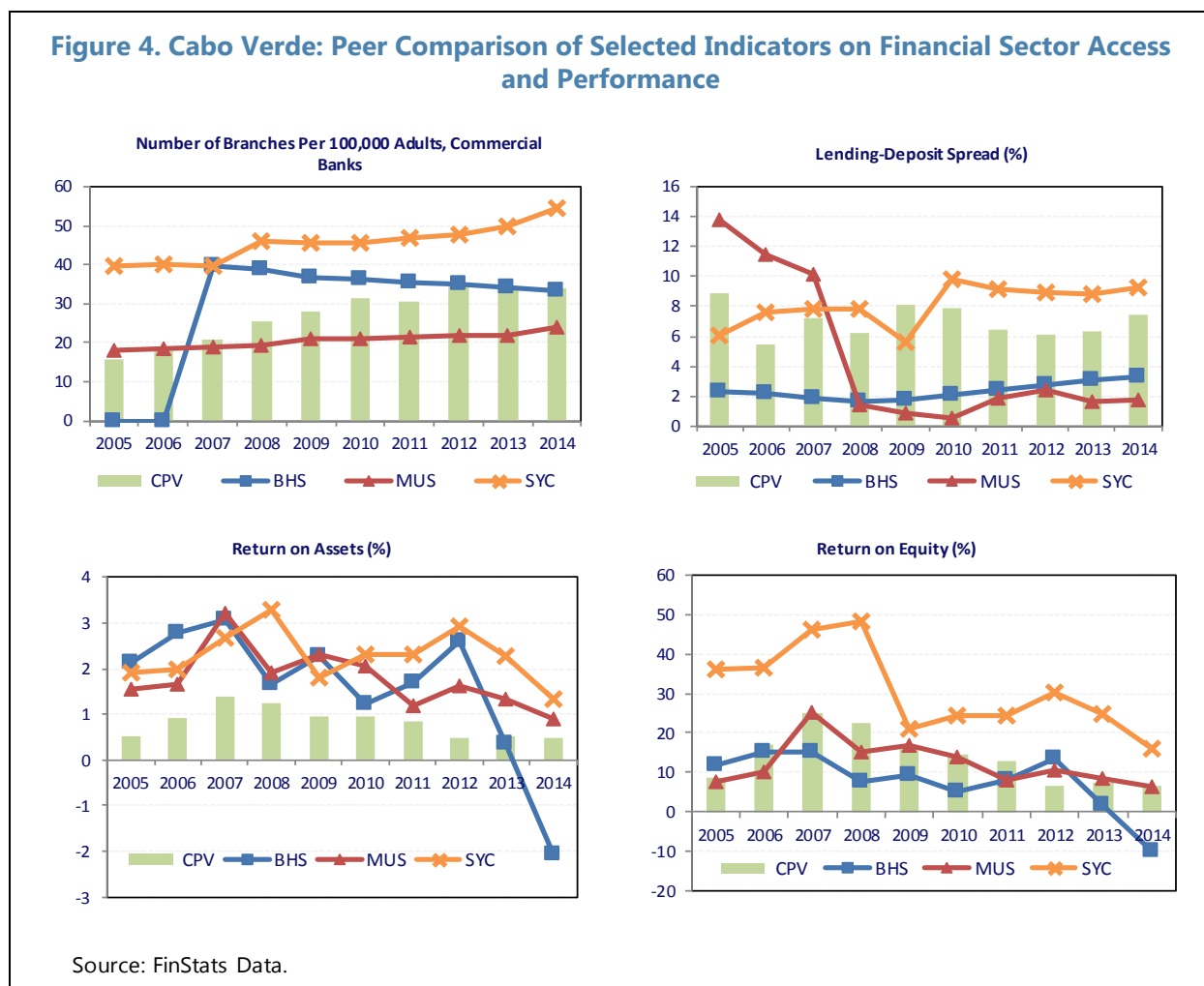
Figure 3. Cabo Verde: Peer Comparison of Selected Indicators on Financial Breadth and Depth



Source: Finstats Data.

14. While Cabo Verde's private credit to GDP is higher than Seychelles', it is significantly lower than in Mauritius and The Bahamas. This is not entirely surprising, as both enjoy significantly higher income per capita, as well as proximity to large markets. This has helped boost the offshore banking sector and develop the financial sector in general, which is also reflected in the much higher insurance company assets to GDP ratio.

15. Cabo Verde is a very strong performer in the area of access to banking, even when compared with higher income peers (Figure 4). Cabo Verde has a larger number of branches per 100 adults than Mauritius, and, as of 2014, is roughly at the same level as The Bahamas.



16. However, performance and profitability indicators suggest that the banking sector in Cabo Verde has a lot of catch-up to do. The lending-deposit spread is higher only in Seychelles, and significantly lower in The Bahamas and Mauritius, suggesting that the banking sectors in the latter two are doing a much better job in channeling resources to the private sector. On the other hand, bank profitability as captured by ROA is significantly better in Mauritius and Seychelles.

Summary

17. Taken together, the performance and profitability indicators could indicate that Mauritius and The Bahamas have deeper and more liquid banking systems, also reflecting their status as offshore banking centers, that have recovered better from the recent global recession. However, they could also point to an overcrowded banking system in Cabo Verde, where, despite the higher spreads, the relative lack of investing opportunities and the high number of banks could be a factor that keeps banking sector profitability low. Tapping into the small and medium-sized enterprise sector for business loans could help diversify assets and improve profitability. In addition, consolidation of the banking sector could be needed to enhance economies of scale.

CABO VERDE: GOVERNMENT FINANCING AFTER CONCESSIONAL BORROWING

This note explores several government financing options for Cabo Verde in the eventual aftermath of concessional borrowing. The alternatives discussed are i) international sovereign bonds, ii) syndicated bank financing, iii) expanding domestic debt issuance, iv) opening up the domestic bond market to foreign participants, and v) diaspora bonds. There is no clear winner, and a mix of some of the options above could be considered based on a cost-benefit analysis taking into account borrowing costs while containing currency risks, interest rate volatility, and private sector crowding-out.

A. Introduction

1. **After graduating to middle-income country status in 2008, Cabo Verde sought to take advantage of the closing window of concessional borrowing to scale up capital investment.**

Coming at a time of global recession, the scaling-up aimed at eliminating infrastructure gaps impeding private investment and growth while providing a much-needed counter-cyclical boost to the economy. As a result of the scaling up in public investment, over 2009–13 capital spending (including onlending to SOEs) averaged about 15.3 percent of GDP, or over 50 percent higher than during 2003–5.

2. Although the scaling-up of public investment is expected to come to an end, and capital spending to return close to historical average in the medium term, eventual upgrades of the recently built infrastructure could be costly. In addition, scaling-up notwithstanding, further public investment could be needed, especially to bolster knowledge-intensive sectors and increase their productivity. Furthermore, Cabo Verde is a Small Middle-Income (SMIC) island country highly dependent on tourism and, with its currency pegged to the euro, countercyclical government spending is likely to remain the main policy tool in face of external demand shocks. Consequently, the ability to mobilize sustainable financing resources as the concessional borrowing window closes remains crucial to the country's development and macroeconomic management.

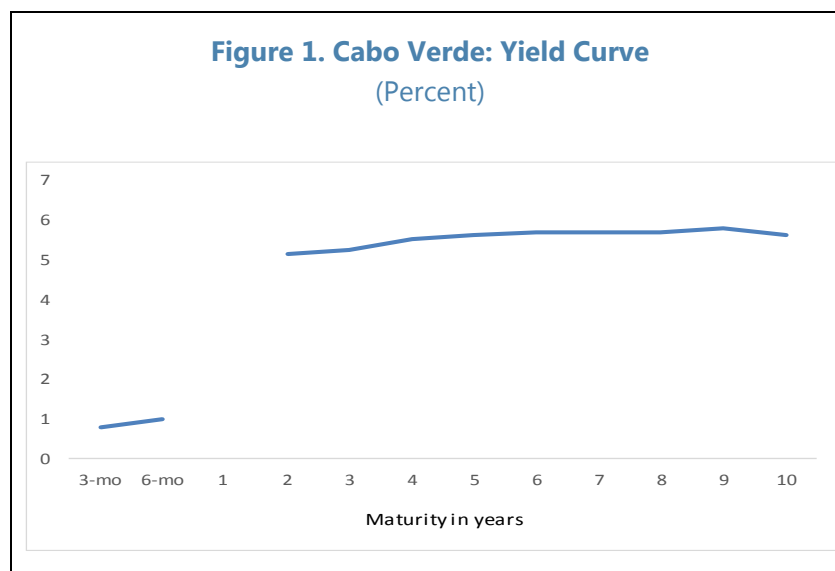
3. As concessional borrowing opportunities are phasing out, Cabo Verde needs to explore new sources of financing public investment and the fiscal deficit. This note explores various alternatives which could help a smooth transition out of concessional financing. In addition, the note will draw on the literature and on other countries' experience to discuss implications for monetary and fiscal policy, and macroeconomic stability.

B. Domestic Market: Actors and Maturity Structure

4. The domestic government debt market has a narrow base, and is dominated by few participants. At the end of 2015 about 42 percent of government bonds and bills were held by the social insurance fund Instituto nacional de Previdencia Social (INPS), and five (out of eight) banks held about 56 percent.

5. The size of the INPS, combined with a financial situation expected to remain strong in the near future, have contributed to making the latter a major source of demand for government debt instruments. On the other hand, for the past couple years the banking system has had significant excess liquidity. This and the poor investment opportunities owing to the downturn of tourism related real estate and domestic demand have led commercial banks to strongly invest into government bonds.

6. The maturity mix of government debt instruments is overwhelmingly concentrated on the long term. By end-2015 T-bonds constituted the entirety of the marketable debt instruments in the domestic market, and all 3- and 6-month T-bills had reached maturity. There is a maturity gap, as currently there are no instruments with maturities between 6 months and 2 years. Issuance of medium-term instruments would help meet demand for medium-term maturities, and provide reference points in the presently fragmented yield curve (Figure 1). This could be taken into account when updating the debt financing architecture.



C. Financing Options: Risks and Opportunities

7. Considering future needs, the present state of the financial market, and several key characteristics of financial flows in Cabo Verde, several alternative financing options could be explored. This section will focus on, and discuss the potential policy implications of: a) international sovereign bonds; b) syndicated bank financing, c) expanding domestic debt issuance to tap domestic savings; d) opening up the domestic market to foreign participants and; e) issuance of diaspora bonds.

International Sovereign Bonds

8. Issuance of international (foreign-currency denominated) sovereign bonds by frontier economies has increased in sub-Saharan Africa (SSA) over the last decade, helped by low global interest rates, low risk aversion, and search for higher yields outside advanced economies (AEs) and emerging markets (EMs). Improved macroeconomic stability and optimism about the continent's potential and have helped attract investor attention, and higher public investment has contributed to higher demand for external market funding. Several countries have issued international bonds to finance infrastructure projects and debt restructuring (Table 1).

Table 1. Sub-Saharan Africa: Sovereign Bond Issues, 2006–15

	Year	Yield at Issue	Tenor	Spread (bps)	Size (\$ mn)	S&P (rating at issue)	Currency
Seychelles	2006	9.466	5	470	200	B	USD
Ghana	2007	8.500	10	387	750	B+	USD
Gabon	2007	8.250	10	426	1000	BB-	USD
Republic of Congo ¹	2007	8.770	22	458	480	Not rated	USD
Senegal	2009	9.473	5	691	200	B+	USD
Seychelles ¹	2010	5.000	16		168	Not rated	USD
Côte d'Ivoire ¹	2010	17.354	22	393	2330	Not rated	USD
Nigeria	2011	7.126	10	372	500	B+	USD
Senegal	2011	9.125	10	583	500	B+	USD
Namibia	2011	5.835	10	336	500	Not rated	USD
Zambia	2012	5.625	10	384	750	B+	USD
Tanzania	2013		7	600	600	Not rated	USD
Rwanda	2013	6.746	10	499	400	B	USD
Gabon	2013	6.375	11		1500	BB-	USD
Zambia	2014	8.625	10	598	1000	B+	USD
Kenya	2014	5.875	5	418	750	B+	USD
Kenya	2014	6.875	10	429	2000	B+	USD
Côte d'Ivoire	2014	5.375	10	290	750		USD
South Africa	2014	5.375	30	219	1000		USD
South Africa	2014	3.75	12	225	673		USD
Senegal	2014	6.25	10	368	500	B+	USD
Ghana	2014	8.25	11	571	1000		USD
Ethiopia	2014	6.625	10	438	1000		USD
Ghana	2015	10.875	15	883	1000		USD
Zambia	2015	9.375	12	712	1250	B	USD
Gabon	2015	6.95	10	451	500	B+	USD
Côte d'Ivoire	2015	6.625	13	454	1000		USD

Sources: Mecagni et al, 2014, and AFR Regional Studies, 2014.

¹ Issued in the context of debt exchange/restructuring.

9. International bonds can help diversify the lender base and provide a benchmark for private corporate borrowing. In addition, access to competitive markets can lead to increased scrutiny, high responsiveness of debt pricing to fiscal and macroeconomic parameters, and improved fiscal discipline. It could improve the monitoring and quality of public investment projects that the bond is expected to finance. In many cases international sovereign bonds can help improve the debt's maturity structure, or lower debt servicing costs by substituting higher-interest rate instruments with less costly ones.

10. On the other hand, issuing international bonds carries several risks, with currency risk being the most prominent. While issuing in foreign currency is not theoretically necessary, in

reality that is how all international bonds in SSA have been issued¹. The local currency could depreciate by the time the principal is due, and increase the cost of debt service. For countries with a peg to the Euro, like Cabo Verde, issuing in Euro could be an option, although that market is smaller and less liquid. Also, for bonds with a bullet repayment structure, the principal might have to be paid at a time when interest rates are higher and rollover can be costly. Although global interest rates are quite low at the moment, policy makers need to take into account the possible economic environment at the time of repayment. Furthermore, while issuing sovereign bonds can help private and other non-state entities obtain lower cost loans, it can increase risks coming from private sector exposure.

11. The operational costs associated with being a debut issuer should be carefully considered. The cost of setting up the legal framework and contracting international companies to prepare the grounds for issuance could be significant. In addition, there might be a lower bound on the amount issued, which would penalize small countries like Cabo Verde. For example, the smallest sovereign bond issued in SSA so far has been a US\$ 168 million Seychelles bond. That amounts to about 11 percent of Cabo Verde's GDP, pointing to significant scale constraints for the country.

Syndicated Bank Financing

12. Syndicated bank financing could enable the country to reap benefits similar to those of international bonds while reducing some of the costs. Benefits would include increased flexibility, as syndicated loans could be issued at smaller amounts and better-tailored to needs, especially in the case of small countries. In addition, issuance costs would be lower and key operational aspects, would be delegated to the bank or banks issuing the loan. In contrast to bond issuance in euro, it should be much easier to have euro-denominated loans. On the other hand, much like international sovereign bonds, syndicated loans would come with currency risk if not issued in Euro.

Expanding Domestic Issuance to Tap Domestic Market

13. Expanding domestic bond issuance could be a less risky financing alternative. Operational costs would be significantly lower than those associated with international bond issuance. For Cabo Verde there is no obvious interest rate advantage of international sovereign bonds over domestic 3–8 year T-bonds, which might indeed issue at a lower yield. Furthermore, there is no currency risk involved.

14. However, expanding domestic bond issuance has certain disadvantages. The country would not be able to benefit from the benchmarking externalities of international sovereign bonds. In addition, expanding domestic issuance could tighten the competition for funds between the public and private sector, and lead to the latter being crowded out. This could further weaken private credit in Cabo Verde, which has already been severely affected by the global and domestic

¹ Pedras et al (2014) point to investors' lack of trust in the sovereign based on past transgressions as one of the probable reasons for foreign currency issuances.

demand downturn. Policies to strengthen domestic savings could help in that respect but likely would take time to yield results.

Opening up the Domestic Market to Foreign Participation

15. Opening up the domestic bond market—or even a selected maturity segment of it—to external players could be a viable alternative. Foreign participation would boost international reserves in the short-term, and could provide additional lower-cost financing with no currency risk. On the other hand, it could expose the country to significant, if infrequent, rollover needs. In addition, the increase in international reserves and the ensuing liquidity transfer to the government could necessitate significant sterilization efforts.

16. Sterilization could be costly. The net benefit of foreign participation compared to sterilization costs would depend on: i) the interest rate decrease in the segment open to foreign participation, ii) the gain from lower external financing costs vis-à-vis the alternatives (e.g. international sovereign bonds, iii) the size of the sterilization effort, and iv) the rate of remuneration for the central bank instruments used in the process. In addition, in the current global environment of very low interest rates, the cost of investing the additional international reserves should be taken into consideration.

17. To mitigate rollover risks one could initially envision limiting foreign participation to the longer-term bond segment. Furthermore, given that the maturity range of the bulk of domestic debt is already 3–8 years, policy makers could, at the same time, issue debt with a maturity of 1–2 years and limit participation in that segment to domestic actors. Concerns about being able to meet recurring rollover needs could also act as an incentive for fiscal discipline and macroeconomic stability.

18. While contributing to a more liquid domestic debt market, diversifying the investor base and reducing borrowing costs, foreign participation could potentially increase volatility. Capital flows could dry up owing to increased risk aversion or other factors unrelated to a country's fundamentals (Calvo and Talvi, 2005). Similarly, expectations of a winding-down of unconventional monetary policy (UMP) in the USA and EU are believed to have contributed to currency volatility in several EMs during 2014. Peiris (2010) finds that while foreign participation contributes to a decrease in yields, there is no evidence of its impact on increasing volatility in EMs. However, while regression results can point to mostly beneficial effects for an EM sample, the impact on volatility could vary from one country to another, and the authorities should be cautious. This would apply in particular to Cabo Verde where the size of the domestic debt market would be small relative to the size of potential foreign investment, in particular from the eurozone.

19. Several SSA middle-income countries have opened their local currency government bond markets to external investors (OECD, 2013). However, in practice foreign participation remains marginal in most countries, and has reached significant levels in only a few, such as South Africa and Ghana. Anecdotal evidence points to macroeconomic and currency stability being important factors in attracting foreign investors in the long term. Botswana, for example, after a

good start with the 2-year bond issued in 2003, saw its currency depreciate shortly before the time of the bond's maturity in 2005, and has not been able to attract significant foreign participation since then (AfDB 2010).

20. There is little SMIC experience to draw from, with the exception of Mauritius, where foreign participation remains low. The reluctance of other SMICs to open up their domestic markets to external investors could be a result of the policy makers' risk aversion in face of the potential increase in volatility and exposure to rollover needs. It could also reflect the inclination to limit interest payments to domestic actors and support domestic financial institutions. However, its relative attractiveness might increase in case domestic funding constraints become binding.

Diaspora Bonds

21. Diaspora bonds would help mobilizing migrant savings, and could represent a cheap and stable source of external financing. Nationals abroad have an emotional link to the country, and they often perceive country-related risks as lower than international investors. While nationals abroad could be more sanguine about the possibility of currency devaluation, this could be mitigated by issuing the diaspora bonds in foreign currency.

22. Elsewhere, diaspora bonds have been aimed at financing infrastructure projects which have a tangible impact and make investing in one's country of origin more attractive. While carrying the same risks as international sovereign bonds, diaspora bonds could be offered at a lower spread, leaving both the government and the investors with a surplus vis-à-vis other institutional borrowing/investing alternatives. In addition, diaspora bonds could be issued in smaller sizes.

Table 2. Sub-Saharan Africa: Diaspora Bonds Issuance, 2008–15

Country	Date of Issuance	Amount and Currency	Maturity	Interest Rate	Special Features
Ethiopia	2008	unknown	5, 7, 10 yrs	Fixed, 4%, 4.5%, and 5% depending on maturity	Limited to Ethiopians with access to FX
Ethiopia	2011	Amount unknown (but project cost was \$4.8 billion)	5-10 yrs	5yr: Libor + 1.25%, 6-7 yr: Libor +1.5%, and 8-10yr: Libor +2%	Sovereign Instrument
Zimbabwe	2011	\$68 million	3 years	Fixed, 8.5%	Issued by CBZ, floated on the Cayman Stock Exchange.

Source: IMF Country Report 14/232

23. However, it should be noted that migrant financial flows to Cabo Verde already go beyond remittances, with significant amounts of migrant term deposits. Issuing a diaspora bond would likely put the government in competition with the banks, increase competition for migrant deposits between commercial banks and raise interest rates for migrant deposits, and lower private investment.

D. Conclusion

24. As the concessional borrowing window comes to a close, Cabo Verde needs to consider other financing options. Policy makers need to weigh the costs, benefits and feasibility constraints of several alternatives discussed in this note before selecting a strategy. While all of the above mentioned strategies have their pros and cons, euro-denominated syndicated loans alongside carefully further developing the domestic bond market might be a combination worth considering. Depending on the policy mix, this could help mobilize external resources with a higher flexibility and lower institutional costs, contain the sterilization costs associated with large foreign currency inflows, contribute to a more liquid domestic market, and prevent crowding out.

25. Whichever the policy course, the country should maintain a sound macroeconomic framework and prudent fiscal outlook, consistent with debt sustainability. Diversifying financing sources should not come at the cost of higher public debt, private sector crowding out, increased volatility and impaired growth prospects. Alternative borrowing arrangements should be subject to a careful debt management analysis aiming at improving the profile and composition of the public debt. Finally, policy makers should aim at communicating their decisions to the public in a clear way, and give domestic and external actors the time to adjust to the new market conditions.

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