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MONETARY TRANSITIONS IN CABO VERDE: FROM THE ESCUDO ZONE TO THE EXCHANGE AGREEMENT WITH PORTUGAL¹

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Abstract

During the colonial period and within the framework of the monetary system of the Portuguese colonies, Cabo Verde lived in a situation of relative monetary and exchange stability. After independence, in 1975, the country underwent two monetary transitions: the first, immediately after independence and with the abandonment of the exchange rate parity with the Portuguese escudo; and the second, from 1998 onwards, following an exchange cooperation agreement with Portugal. During both transitions, the country could rebuild monetary and exchange stability, as a result of the way in which institutional and external factors of stability were used in each of them. However, the second transition significantly affected the evolution of trade and international investments in Cabo Verde, whose expansion resulted in a strong growth of the economy and exports. This paper analyses not only the conditions of monetary and exchange stability in the two transitions, but also the nature of the changes that took place with the second transition. Those changes were reflected in a trend of structural transformation and consolidation of the market economy in Cabo Verde, paving the way to the good economic performance of the last few decades.

Keywords Cabo Verde; monetary transition; exchange stability factors; exchange cooperation agreement.

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INTRODUCTION

In the second colonial system, since the nineteenth century, the European powers promoted the commercial integration of the colonised areas using monetary and banking integration as an instrument. Colonial banks were established, often with a monopoly of action, as well as colonial monetary systems based on currencies with a local circulation but pegged to metropolitan currencies, of which they were essentially a local representation. The monetary integration models ensured monetary and exchange stability in the colonies and, indirectly, the convertibility of their currencies (Schuler 2003; Estêvão 1991b).

After the post-World War II political independences, most new countries eventually abandoned the colonial monetary systems in which they were integrated, opting for the creation of central banks and the issue of their own currencies. Some countries created currency boards while others, which had belonged to colonial monetary zones, replicated them through new agreements with the former colonial powers. Contexts of rupture led to processes of monetary disintegration, which had repercussions like situations of instability and the weak development of banking and financial structures. In the cases of post-colonial continuity of the monetary pegging, the evolution was much more stable (Schuler 2003; Honohan and O'Connell 1997).

Cabo Verde had belonged, since 1901, to the monetary system of the Portuguese colonies, a system that was later integrated in the Escudo zone, thus operating between 1963 and 1974. After independence, the country went through two monetary transitions: (i) first, in a context of rupture and monetary autonomy (1976-1998), with the creation of a central bank and the issue of its own currency; (ii) afterwards, with the establishment of an exchange agreement with Portugal, in 1998, Cabo Verde once again pegged its currency to the Portuguese escudo (later the euro) in a fixed parity relation. Monetary and exchange stability had been the norm during the colonial period and became so again recently, with the exchange agreement. However, even though the first post-colonial transition was a monetary rupture, the country eventually reached a relative stability, based on the application of instruments of policy and foreign exchange management.

The main objective of this paper is to analyse how, in each one of those two monetary transitions, the conditions of monetary and exchange stability that came from the colonial period were reconstructed. On the other hand, considering the second monetary transition and the exchange agreement with Portugal, this paper also intends to show the effects that the new stability had on the recent economic performance of Cabo Verde and on the changes in its economic model. Section II of the paper examines the factors of monetary and foreign exchange stability in Cabo Verde during the colonial period, section III explores the first monetary transition post-independence and section IV analyses the second monetary transition and the exchange agreement with Portugal, besides highlighting its effects on the Cape-Verdean economy and the sense of change that it has stimulated.

1. THE MONETARY AND EXCHANGE STABILITY IN CABO VERDE DURING THE COLONIAL PERIOD²

The monetary and exchange stability in Cabo Verde began to be constructed in the second half of the nineteenth century, with the combination of two fundamental pillars (Estêvão 2015): (i) the ability to raise foreign exchange developed in the last few decades of the century (*external factor*); and (ii) the creation of the colonial monetary system (*institutional factor*) with the institution of the Banco Nacional Ultramarino (BNU)³ in 1864 and, later, the contract between the State and the BNU on 27 April 1901 which instituted *de facto* the colonial monetary system.

At the turn of the twentieth century, the main external resources that would shape the dynamics of the economy throughout most of the colonial period were already established, namely remittances and foreign exchange from Cape-Verdean emigrants and foreign exchange and bills of exchange on foreign countries negotiated by the British coal mining companies established in S. Vicente. The significant volume of foreign exchange

² The subjects of this section are developed in Estêvão (2015), particularly in chapters 4 and 5, pp.141-206.

³ The BNU was established in Portugal in 1864. Its first branch in Cabo Verde was created in 1865, in Praia, by a *Portaria* of 4 October, which prescribed that the Bank's notes must be accepted in all public offices.

that circulated in Cabo Verde generated intense competition among the different players, like the BNU, the coal mining companies, the archipelago's main trading houses, small local merchants and the metropolitan banks, the latter without a physical presence in the isles. In other words, the foreign exchange business was, both formally and informally, one of the most important businesses in Cabo Verde and a fundamental basis of its economy (Estêvão 2015).

The establishment of the colonial monetary system in 1901 was the second key pillar for guaranteeing monetary and exchange stability. In its essence, the system included: (i) the circulation of the Portuguese silver coin, with legal tender in the metropolis and the colonies; (ii) the circulation of the BNU banknotes, with their legal tender restricted to the colonies, but convertible into the metropolitan silver coin; and (iii) the compulsory exchange of those notes at the Bank's headquarters in Lisbon, which was key to prevent the outflow of silver coins from the colony and to promote the circulation of banknotes as a means of payment. Banknotes and payment orders on Lisbon were always accepted at the BNU's headquarters, in parity with the metropolitan currency, allowing a relatively stable running of the colonial monetary system until the beginning of World War I (Estêvão 1991b).

The moments of instability were always connected to the bankruptcy of one of those pillars or to the ineffectiveness of their articulation. The beginning of World War I brought along the disappearance of the silver coin and the ban on transfers of metal coins between the metropolis and the colony, which made it harder to convert colonial banknotes and led, therefore, to the bankruptcy of the colonial monetary system. Wartime and post-war inflation increased the monetary and economic instability; however, there were no significant changes in the exchange rate of the Cape-Verdean currency. It was not until 1923 that there was a significant increase in the exchange rates of the main foreign exchanges, the US dollar and the British pound, an increase that was not due to the change in Cabo Verde's private banknote circulation, but to a new problem that then afflicted the archipelago – that of exchange rate speculation generated by a great invasion of Angolan banknotes looking for foreign exchange, which Angola desperately needed and which was seen as being abundant in Cabo Verde. The turbulence caused by this invasion deteriorated the economic and financial situation of the colony significantly and

generated great social instability. At that time, the province's banknotes were suffering a devaluation of 15 to 20 per cent in relation to the banknotes of the Banco de Portugal (Estêvão 2015). The issue then was the *external factor* of the Cape-Verdean currency's stability, that is, the permanent availability of foreign exchange.

Without the turbulence of the 1920s, the monetary situation entered a stage of relative calm and went through a period of transition that led to the quick monetary expansion that would occur after World War II. To this end, both the institutional innovations in the monetary system and the rapid growth in inflows of foreign exchange into the archipelago were important. From an institutional point of view, the contracts that were celebrated between the State and the BNU, in 1929 and 1953, were fundamental, as they restored the conditions for convertibility of the colonial banknotes and changed the conditions of currency issue, pegging them closer to the foreign exchange counterparts. The main institutional changes can be summarised in three key points: (i) the full affirmation of the metropolitan foreign exchange standard, as the monetary reserve began to be mainly composed of Portuguese escudos, or values that represented them; (ii) centralisation of the monetary reserves and their management by the *Fundo Cambial*⁴, whose values were meant to guarantee the regularity of external payments and to mitigate exchange rate fluctuations; (iii) preference for currency issue based on the counterparts of the *Fundo Cambial* and fully guaranteed by external values (Estêvão 1991b). A currency restricted to the colony and managed according to its economic needs, with an issue mainly based on foreign exchange counterparts, allowed the creation of a stronger relationship between the two – institutional and external – pillars of monetary and exchange rate stability.

The new mode of currency issue, which depended on the inflows of foreign exchange, was a factor that permitted to sustain the high rate of post-war monetary expansion. Other key factors were connected to the expansion of the basis for the raising foreign exchange that then took place: (i) the growth in service revenues (ports, airports, etc.); (ii) the increase in remittances of emigrants with the new wave of emigration to Western Europe; and the transfers of funds from the metropolis to activities included in

⁴ The *Fundo Cambial* (Foreign Exchange Fund) was defined as 'the sum of the values given to the Bank as guarantee or execution of external payments of any overseas province'. *Decreto-Lei* n. 39221, *Diário do Governo* n.109, p. 775.

the *Planos de Fomento* (Portuguese Development Plans) and other actions of colonial public policy.

Table 1 allows us to compare the evolution of the amounts credited to the currency issue account of the *Fundo Cambial* with the evolution of the money supply. As we can see, the *Fundo*'s assets grew at the annual average rate of 20.3 per cent between 1963 and 1973, whilst the money supply grew at the lower rate of 15.9 per cent. If we consider the weight of the *Fundo*'s values in the money supply, we find that it is quite high and that it was always above 50 per cent during that period, reaching a maximum of 70.8 per cent in 1971. These figures clearly show that the values credited to the *Fundo Cambial* were the main source of currency issue and that their rapid growth explains not only the expansion of money supply in the last decades of the colonial period, but also the great stability of the monetary phenomenon in Cabo Verde.

Between 1961 and 1963, a set of new laws significantly altered how the Portuguese economic space worked and tried to promote a process of national economic integration and the institution of the Escudo Zone (Clarence-Smith 1985; Estêvão 1991b). The decree-law 44016 of 8 November 1961 embodied the passage to the new colonial policy, which was meant to increase the restructuring and national integration of the colonial economy⁵. There was, mainly, an idea of a system that would permit the regularity of transfers, the inter-transferability of currencies and the resolution of the monetary-exchange imbalance, in accordance with the objectives of maintaining domestic financial stability and solvency of the Portuguese currency.

The payment system and the regulation of the functioning mechanisms of the Escudo Zone were established by the abovementioned decree 44016 and by a set of diplomas published in 1962 and 1963. The main measures included in those diplomas were connected with the regulation of foreign exchange trade and external payments, the definition and ranking of the functions of each of the institutions that intervened in the system, the setting up of mechanisms of clearing and inter-territorial payments and the regulation of the banking and colonial credit system.

From the point of view of the monetary system, three main changes were relevant: (i) the autonomy of the *Fundo Cambial*, which began to work as a central reserve of gold,

⁵ Decreto-Lei n.º 44016, *Diário do Governo* n. 259, pp. 1371-1379.

foreign exchange and other means of external payment; (ii) the expansion of functions of the Banco de Portugal, which also became the central and reserve bank of the Escudo Zone and an agent of the clearing system and of the then recently created Monetary Fund; and (iii) the establishment of the Monetary Fund of the Escudo Zone to facilitate the functioning of the system and to help the regularisation of inter-territorial and international payments through loans granted to the *Fundo Cambial* (Estêvão 1991b).

In the new institutional structure, the Banco de Portugal operated as a central reserve for the *Fundo Cambial* of each colony and it should channel their foreign assets into their respective accounts at that bank. The institutional basis of the system was composed of all the issuance banks from the metropolis and the colonies, the latter in their capacity as agents of all the different *Fundos Cambiais*. Each bank should open clearing accounts on behalf of each of the other ones, where payment transactions would be registered and through which bilateral balances would be calculated, as well as the net position of each territory based on accounting periods. The Banco de Portugal, as an agent of the system, would be the executor of the clearing operations of the bilateral balances and the regularisation of the net position of each territory.

Table 2 shows the evolution of the credits from Cabo Verde's reserve account within the inter-territorial payments system, between 1963 and 1973. The colony had an almost permanent deficit in payment operations with other territories, which reflected the fact that the credits made by Cabo Verde through these operations only accounted for, on average, around 46 per cent of the total credits of its reserve account. Clearing was possible because the colony was able to maintain a high level of foreign exchange sales to the Banco de Portugal, which allowed the regularisation of its debit position and the maintainability of positive overall balances at the end of each accounting period. The contribution from this sale of foreign exchange corresponded, on average, to around 45 per cent of the total of credits from the reserve account, with contributions reaching well above 50 per cent on several years. The favourable position attained by Cabo Verde allowed it, during the last years of that period, to transfer part of its balances to deposit accounts in the Banco de Portugal, the central bank of the Zone.

Table 1
Fundo Cambial's currency issue account and money supply, 1964-1975

	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975
Fundo Cambial (millions of escudos)	41,2	32,8	65,2	82,6	99,6	96,0	112,1	171,9	175,3	147,1	290,8	383,7
Money supply (millions of escudos)	91,8	102,3	126,3	145,8	169,5	178,7	204,5	242,9	276,7	332,2	461,2	586,6
Fundo Cambial / money supply (%)	44,9	32,0	51,6	56,6	58,7	53,7	54,8	70,8	63,3	44,3	63,1	65,4

Sources: Banco Nacional Ultramarino's balance sheets of December; Estêvão (2015).

Table 2
Cabo Verde's reserve account credits in the escudo zone payment system, 1963-1973 (% of total)

	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	Average
Gold and exchange sales to the Banco de Portugal			69,5	32,7	46,0	56,9	56,6	45,4	76,4	10,5	6,8	44,5
Inter-territorial payments	69,6	56,4	21,4	62,3	38,5	38,5	9,6	27,1	21,0	79,2	79,9	45,8
Credit balance of the previous year		13,0	0,2	4,9	15,5	4,7	33,7	27,5	2,6	9,4	10,5	12,2

Sources: Banco de Portugal, Sistema de Compensação e de Pagamentos Interterritoriais, *Relatório do Agente*, several years.

2. THE POST-INDEPENDENCE MONETARY TRANSITION IN CABO VERDE

Cabo Verde's independence led to a monetary transition process in the archipelago that had as its first achievements the creation of the Banco de Cabo Verde (BCV), in 1975, and the establishment of the Cape-Verdean escudo as the national currency unit, in 1977. The creation of the BCV took place just over two months after the independence, through a Decision of 19 September 1975⁶. The promptness of that decision was justified with the need for the country to fully assume all attributes of sovereignty and to exercise its inalienable right to issue money. However, that promptness also had to do with the need to prepare the institutional conditions to receive the transfer of the BNU department in Cabo Verde, including its assignments and the assets and liabilities of its three dependencies. In 1975, monetary and exchange issues posed serious governance problems and the new political power was devoid of instruments of action, as monetary issue was the responsibility of a now foreign bank. In addition to this, the BNU was still an agent and banker of the *Fundo Cambial*, which was responsible for the management of reserves and the regulation of exchange operations. These were precisely the issues that the legal diploma emphasised when presenting the reasons for the creation of the BCV.

The second act of institutional transformation of the monetary system took place with the birth of the Cape-Verdean currency in July 1977. A set of three diplomas defined and established the Cape-Verdean escudo, authorised the BCV to issue notes and coins that were representative of the national currency unit, put them in circulation and defined the conditions under which the exchange of BNU banknotes and coins in circulation should take place. The decree-law 60/77 of 1 July established the basic principles of the new currency and some rules on monetary substitution: (i) the government would authorise the issuance of banknotes and coins and would set the date on which the BNU species in circulation would cease to have legal tender and discharging power, as well as the conditions for their exchange; (ii) the BCV would

⁶ Decision with force of law 5/75, *Boletim Oficial* n.13, *Suplemento*, pp. 1-2.

determine the value of the Cape-Verdean escudo in relation to other currencies and would prohibit the imports and exports of banknotes and coins with legal tender in the national territory⁷.

The BCV began operations on 1 July 1976. The new institutional configuration concentrated all banking activity in one universal bank with both the functions of a central and a commercial bank. As the central bank, the BCV was the currency issuing authority, but also the State banker, manager of foreign reserves, intermediary in international monetary relations and foreign exchange authority. Also relevant were the functions assigned to the Bank in the field of economic development as it should, within the framework of its ‘general mission’, establish the most favourable conditions for the balanced development of the national economy. As the State banker, the Bank could grant it credit up to 15 per cent of the ordinary revenue collected during the previous year’s budget execution, but also grant it credit outside the 15 per cent rule; in those situations, the credit limits would be dependent on the definition by the Government of the needs of public financing, which should be adjusted to the conditions generating currency issue each year.

During the 1980s, Cabo Verde adopted a strategy of centralised planning and management of the economy, a period when two five-year plans were implemented. The process of economic development led by the State posed three fundamental questions that influenced the priorities when it came to how the monetary dimension of the economy functioned: (i) central planning of investments; (ii) industrialisation by import substitution and (iii) financing mainly based on official development assistance and foreign loans. In this model of financing, credit needs were determined by centrally decided investment plans, whilst most of the financing originated from abroad and arrived at the Banco de Cabo Verde, constituting foreign liabilities and a fundamental counterpart of the currency issue.

In 1985, important changes in the banking sector reflected the development model that had been established. The organic law of the BCV was amended on 3 August by the decree-law 82/85 which added the function of development bank to the other roles it already played. This new function was performed by the Investments

⁷ Decreto-Lei n. 60/77 [creation of the Cape-Verdean escudo]. *Boletim Oficial* n. 26, *Suplemento*, pp. 1-2.

Department, which also managed foreign lending facilities for small and medium-sized enterprises, namely those of the World Bank. On the other hand, the decree 167/85 of 30 December determined the transformation of the Caixa Económica Postal into a State company named Caixa Económica de Cabo Verde (CECV), with the aim of organising it and therefore allowing it to cooperate more actively in the execution of the credit policy. The CECV would be able to receive demand deposits and time deposits and to grant personal and housing credits. In order to achieve its objectives, it could obtain funds from the BCV under the terms and conditions that were agreed upon. The banking system was then comprised of two banks, the BCV – central and commercial bank – and the CECV – with commercial and credit functions – both public law organisations.

During the first post-colonial monetary transition, Cabo Verde eventually reconstructed the external and internal factors of monetary and foreign exchange stability. Under the development plans, the Cape-Verdean economy became dependent on both emigrants' remittances flows and official development assistance. This new model, like the so-called MIRAB economies (Bertram & Waters 1985; Bertram 2006), was based on the relation between two stock-flow pairs: the 'migration-remittances' pair, in which the emigrant stock allowed a flow of remittances to their families; and the 'aid-employment' pair, in which the flow of official development assistance sustained the stock of employment, mainly in the public sector of the economy⁸. The importance of the two types of external flows is shown in Table 3, where together they accounted for more than 50 per cent of the GDP during the 1980s. The two pairs of flows (*external factor*) permitted the administration of the economy, sustained the process of money creation and allowed the management of the availability of foreign reserves.

In its essence, the country's macroeconomic management was supported by maintaining a great ability to attract official assistance and by a significant level of remittances. The foreign exchange that went in was parsimoniously managed by the BCV and, at the same time, there was a high control over imports and the availability of foreign exchange to economic agents. Therefore, the management of foreign

⁸ Bertram & Watters (1985). It is the nexus between the two pairs of stock-flow that gives us the acronym MIRAB (**MI**gration, **R**emittances, **A**id, **B**ureaucracy).

exchange was based on two fundamental practices (*institutional factor*): (i) the upkeep of a quasi-fixed exchange rate in relation to the currencies of the main economic partners; and (ii) the administrative control of foreign trade and financial operations.

When, in 1977, the parity between the Cape-Verdean escudo and the Portuguese escudo was abandoned, the Cape-Verdean government opted for the daily fixing of the exchange rate from a basket of currencies that represented the 18 most important trading partners. That number was continually reduced in order to guarantee greater exchange rate stability and, in the early 1990s⁹, there were 9 currencies in that basket (Estêvão 1991a). Table 4 shows us a course of relative stabilisation of the Cape-Verdean escudo's exchange rates in relation to the three main currencies of the basket. The Cape-Verdean currency appreciated, in relation to the Portuguese escudo, at an average annual rate of 4 per cent, with maximum variations of 11.9 and 11.4 per cent in 1983 and 1984, respectively. During that same period, the Cape-Verdean escudo depreciated against the British pound and the US dollar at the average rates of 1.8 and 3.7 per cent, respectively, with a maximum depreciation of 8.6 per cent against the British pound in 1988 and 23 per cent against the US dollar in 1983.

A set of administrative controls over all transactions involving foreign currency was associated to the quasi-fixed exchange rate regime. Foreign trade transactions were subject to the BCV's direct control: imports, exports and re-exports of more than 10,000 escudos were subject to licensing. Import licenses required an authorisation from the BCV and that authorisation automatically guaranteed the provision of the foreign exchange necessary for payments. The sum of available foreign exchange was defined annually, it was individually allocated to the companies and distributed quarterly. Only licenses for the import of medicines, capital goods and other equipment were given without restrictions. As for exports, their revenues should be repatriated in the currency determined by the BCV and within three months of the granting of the license. Payments of invisible currents required prior authorisation and the outflow of foreign exchange was controlled through limits imposed on foreign travel. Transactions of

⁹ The weight of each currency was calculated by weighing its importance on Cape-Verdean imports (2/3) and on remittances received by Cabo Verde (1/3). Currency weights were periodically updated, in order to keep up with the relative importance of each partner.

private capital were subjected to prior approval, even though imported capital could be re-exported without limits.

In contrast to what happened during the colonial period, when the pegging of the Cape-Verdean escudo to the metropolitan currency guaranteed in practice its external convertibility, the institutional and administrative mechanisms of the post-independence transition created a rupture with other countries and determined the inconvertibility of the national currency (Schuler 2003). However, those same mechanisms made it possible to manage the inflows of foreign currency, keeping the exchange rates quasi-fixed with the basket of currencies and guaranteeing a level of reserves that ensured the relative stability of the system. Table 5 shows us that the country maintained, throughout the period, an average level of foreign reserves of around 78.5 million US dollars, representing an average of 5.9 months of imports. This situation was sustainable for as long as it was possible to maintain the level of foreign exchange inflows, namely through official development assistance disbursements, and while it was possible to guarantee the country's political and economic management.

Table 3
Official development assistance and personal remittances, 1982-1992

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Official development assistance (ODA) (%)	36,5	40,6	45,9	46,7	54,6	35,9	31,2	31,0	34,3	31,9	32,6
Personal remittances (%)	18,4	14,8	15,6	15,1	14,0	14,8	15,4	16,6	18,3	18,7	20,7
ODA + Remittances	54,9	55,4	61,5	61,8	68,6	50,7	46,6	47,6	52,6	50,6	53,3

Source: World Bank, *World Development Indicators* (<http://databank.worldbank.org>); Estêvão (2015).

Table 4
Annual variation (%) of the average exchange rates (British pound, Portuguese escudo and US dollar), 1982-1992

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	Average
British pound	3,6	6,6	4,0	4,7	-0,6	0,7	8,6	-0,6	-2,6	1,2	-5,5	1,8
Portuguese escudo	-6,9	-11,9	-11,4	-7,4	0,2	-4,1	-2,5	-1,2	-0,7	0,6	1,3	-4,0
US dollar	19,7	23,0	18,2	8,1	-12,5	-9,9	-0,2	8,1	-10,1	1,9	-5,3	3,7

Source: Banco de Cabo Verde (www.bcv.cv).

Table 5
Total reserves in month of imports, 1982-1992

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	Average
Total reserves (US million dollars)	37,8	42,7	45,9	41,0	55,4	56,4	80,7	81,3	74,7	77,0	65,1	75,8
Total reserves (in month of imports)	4,4	4,4	5,0	6,6	6,3	8,2	7,8	6,3	6,0	5,1	4,6	5,9

Source: World Bank, World Development Indicators (<http://databank.worldbank.org>)

3. THE SECOND MONETARY TRANSITION AND THE FOREIGN EXCHANGE COOPERATION AGREEMENT WITH PORTUGAL

In the late 1980s, political pressure led to multiparty elections and, consequently, to a change in the framework of the political parties and regime. The transition process began in 1991 with the first government of the Second Republic, which initiated an extensive set of institutional, political, economic and social changes. From an economic point of view, the new government defined a path of liberalisation, which was reflected in a wave of institutional changes and a true refoundation of the legal and regulatory framework.

The great wave of change happened in 1993-1994 and included changes in several fields, namely commercial banking activities, central bank and foreign exchange operations. In the case of commercial banking, new regulatory standards for the constitution and functioning of banking organisations were introduced, accepting the initiative of national or foreign citizens and of foreign banking organisations to open branches in Cabo Verde. A fundamental institutional change was the definitive separation of the BCV's commercial functions and the creation of the Banco Comercial do Atlântico, which was the successor of the commercial department of the former BCV. In what concerns foreign currency purchase and sale operations, the new legislation allowed credit institutions that were authorised to trade in foreign exchange to fully carry out both foreign currency purchase and sale operations and operations of conversion of one foreign currency into another. These operations could be carried out between credit organisations, between them and their clients and with the BCV. The latter would fix the exchange rates on a daily basis and would issue all the instructions necessary for the performance of foreign exchange operations.

With the Second Republic, there was also a change in how the process of economic development was viewed with the publication of the *Grandes Opções do Plano 1997-2000* (the main options of the plan) the first global action document published after the first wave of reforms, at the beginning of the second legislature. The vision of Cabo

Verde's development was then summarised by the idea of “dynamic integration in the world economic system” (MCE s.d. p.3) from which we can highlight three fundamental aspects. The *dynamic integration*: (i) implied a clear orientation towards the external market; (ii) imposed the need for the development of the market, of the private sector and of human resources; and (iii) their success depended on the ability to take advantage of potential opportunities offered by the world economic system and to turn them into actual opportunities (MCE, s/d pp. 3-5). One of the most important opportunities that the world economy offers is foreign direct investment (FDI). For this reason, raising FDI and finding a strategic partnership for the archipelago became priorities for the economic development of Cabo Verde.

The idea of pegging the Cape-Verdean escudo to the Portuguese escudo should be placed within this framework. During the first transition, as mentioned above, the methods of governmental intervention allowed the reformulation of the articulation between *external factor* and *institutional factor*, which was indispensable to guarantee monetary and exchange stability. However, political and economic model changes destroyed the *institutional factor* built during the First Republic, which led to the necessity of its reformulation. The possibility of a strategic partnership with Portugal, the country's main trading partner, made it possible to think of a fixed peg between the two currencies as an alternative to the basket that had been used until then because exchange stability with the Portuguese escudo would allow to overcome situations of exchange instability in relation to other flexible currencies (Estêvão 2002). Additionally, the reorientation of the economy and political democratisation prevented the reconstruction of the *institutional factor* in a protectionist way, as the process should be conducted in a context of economic liberalisation.

The proposal to peg the two currencies and the beginning of the negotiations also happened at a time of economic crisis in Cabo Verde. For that reason, that option also reflected a search for a solution to the situation, which no longer permitted to support the previous exchange policy and which posed rising problems with the lack of external means of payment (Azevedo 1995; Ramalho 1995). The package of economic reconversion measures, coupled with the progressive reduction in the flows of foreign transfers, ended up reflecting an increasing instability: (i) growth of the public deficit

from 3.4 per cent of the GDP in 1990 to 11.3 per cent in 1994; (ii) shortfall in exchange reserves, from 5.1 per cent of imports in 1990 to 2.2 in 1994 and 0.8 in 1997; (iii) increasing difficulties with the debt service, generating accumulation of arrears; and (iv) level of domestic inflation consistently above the average of the main partner countries, leading to the need for successive devaluations of the Cape-Verdean currency.

It was increasingly urgent to re-establish an institutional mechanism that would make it possible to return to the framework of exchange stability. To that purpose, in March 1995, the Cape-Verdean government expressed to the Banco de Portugal an interest in studying the possibility of pegging its currency to the Portuguese escudo. For the BCV, the study was completely open, revealing no pre-defined position on the actual outline of a possible monetary pegging (Azevedo 1995). There was a wide discussion, namely within the Banco de Portugal, that was focused on three main topics: the nature of the exchange peg, financial facility and macroeconomic conditionality. Some of the ideas that took form and ultimately shaped the agreement were the following (Azevedo & Marques, 1996; Basto & Heitor, 2008):

- The option for a fixed exchange regime pegged to a single currency had the advantage of being more transparent, introducing more discipline and providing greater flexibility in the management of foreign exchange policy.
- Pegging to the Portuguese escudo should be assumed to be unilateral and not to involve any intervention obligations on the part of the Banco de Portugal.
- The agreement should be framed by a monetary arrangement with the inclusion of a credit facility, as the financial support should be granted by the Portuguese Treasury and subject to conditionality.

The Exchange Cooperation Agreement (ECA), signed in Praia in 13 March 1998, established a fixed parity peg between the two currencies, guaranteeing the convertibility of the Cape-Verdean escudo under the following terms: (i) granting a credit facility to Cabo Verde to strengthen its foreign exchange reserves; (ii) adoption by Cabo Verde of the European Union's reference criteria, with the commitment to implement economic policy measures compatible with the safeguarding of the exchange parity and with the creation of conditions for a rigorous management of the credit facility; and (iii) creation

of a Commission for the Exchange Cooperation Agreement (COMACC), made up of representatives of both parties, in order to ensure the proper functioning of the agreement and to manage it¹⁰.

The replacement of the Portuguese escudo by the euro, as referred to in the Article 6 of the ‘Protocol on Credit Facility’, made it necessary to adjust the ECA to the European legal provisions that were to be established. The issue was resolved by the decision of the Council of the European Union, of December 1998 (European Council, 1998), authorising Portugal to keep the agreement in force. The agreement was considered to be of a budgetary nature and the convertibility of the Cape-Verdean escudo should be guaranteed by budgetary commitments of Portugal, which should at the same time ensure that the agreement had no significant financial implications (European Council 1998; ECB 1999). That decision resulted in the replacement of the Portuguese escudo by the euro as the pegging of the Cape-Verdean currency, automatically determining the new exchange value of the Cape-Verdean escudo, with a parity in euros calculated through the irrevocably fixed conversion rate between the euro and the Portuguese escudo: the ratio of 1 Portuguese escudo = 0.55 Cape-Verdean escudos, combined with the irrevocable rate of 1 euro = 200.482 Portuguese escudos, led to the determination of the value of the euro in Cape-Verdean escudos as 1 euro = 110.265 escudos. In addition to the establishment of the new parity of the Cape-Verdean currency, the transition to the euro did not entail any further modification to the principles established by the ECA.

Despite some initial instability due to the crisis in Cabo Verde in the late 1990s, the Agreement has since then operated normally, with no change in its basic conditions or in the exchange rate established in 1998. Its effects on the functioning of the Cape-Verdean economy have been far-reaching. We can analyse these effects on three levels: (i) on the development of relations with the countries of the European Union; (ii) on the stability of the domestic economy; and (iii) on the changes in the Cape-Verdean economy.

The intensity of the economic relations with Portugal and with the European Union was important to support the possibility of pegging the Cape-Verdean to the Portuguese currency. With the ECA there was not only a strengthening of economic relations with the European Union, but also the diversification in the relative position of Cabo Verde’s

¹⁰Decreto 24/98 [approval of the Exchange Cooperation Agreement]. *Diário da República* n. 161, pp. 3386-3388.

main European partners, which can be observed through trade flows, emigrants' remittances and FDI.

Table 6 shows that between 2000 and 2016 exports to Europe accounted for an average of around 85 per cent of the total, and in some years reached well above 90 per cent. If, initially, Cape-Verdean exports were directed mainly to Portugal, there was a significant change from the mid-2000s, as the Portuguese market fell from 88.4 % in 2002 to only 15.1% in 2018, while the Spanish market has rapidly grown since 2006, reaching 65.1% in 2018. In terms of imports, European countries accounted for an average of 76.6% of all Cape-Verdean imports during the period. In this case, the distribution by country remained relatively stable, with Portugal as the main supplier of Cabo Verde, reaching around 50% of the total.

During the same period, emigrants' remittances (Table 7) from European countries accounted for, in average, nearly 75% of the total, mainly from Portugal (28.7%), France (21.7%) and the Netherlands (9.4%). The weight of remittances from the United States of America fell from 30% in 2000 to 18.1% in 2004, accounting for an average of around 20% of the total during the period.

Table 6
Geographical distribution of trade, 2000-2018 (% of total)

	2000	2002	2004	2006	2008	2010	2012	2014	2016	2018	Average
Exports											
Portugal	80,1	88,4	78,3	49,8	40,6	22,7	16,0	14,7	17,0	15,1	42,3
Spain	3,5	0,8	0,3	27,3	37,2	72,6	76,3	63,9	64,2	65,1	41,1
E. U.	86,2	91,1	79,0	77,7	78,3	96,2	92,5	79,4	81,6	80,8	84,3
Others	13,8	8,9	21,0	22,3	21,7	3,8	7,5	20,6	18,4	15,7	15,4
Imports											
Netherlands	13,0	18,1	13,7	11,2	17,0	16,8	15,0	15,6	7,3	6,1	13,4
Portugal	52,4	55,3	42,5	50,2	50,3	51,4	48,2	44,3	49,6	43,1	48,7
Spain	2,5	3,8	3,8	5,6	7,3	10,6	7,2	7,6	11,1	14,5	7,4
E. U.	75,7	86,8	67,5	78,2	82,2	85,4	75,5	72,1	73,1	69,3	76,6
Others	26,9	17,1	36,3	27,4	25,0	25,2	31,6	27,9	26,9	30,7	27,5

Source: Banco de Cabo Verde (www.bcv.cv) and author's own calculations.

Table 7
Remittances by countries of origin, 2000-2018 (% of total)

	2000	2002	2004	2006	2008	2010	2012	2014	2016	2018	Average
France	13,4	22,4	23,5	22,9	22,0	23,0	23,6	21,3	21,0	23,9	21,7
Italy	7,9	4,8	7,7	7,1	6,9	6,3	6,2	6,0	6,7	4,9	6,5
Netherlands	14,7	11,0	9,0	8,9	11,4	8,1	9,3	10,2	5,7	5,6	9,4
Portugal	20,4	25,3	28,8	28,6	30,0	30,7	32,1	32,4	28,8	29,6	28,7
E. U.	63,8	66,9	75,6	76,6	80,1	77,4	79,0	77,6	72,4	72,2	74,2
USA	30,0	27,4	18,1	19,4	14,5	16,6	14,4	14,6	19,7	20,2	19,5
Others	6,2	5,7	6,3	4,0	5,4	6,0	6,6	7,8	7,9	7,6	6,3

Source: Banco de Cabo Verde (www.bcv.cv) and author's own calculations.

The third element that reveals the importance of the European Union to the Cape-Verdean economy is foreign direct investment. FDI flows began to gain importance in the second half of the 1990s with the first privatisation programme and, in the early years, were almost in their entirety from Portugal. In the 2000s, FDI grew significantly, while its sources became more diverse (Table 8). Flows from the United Kingdom have gained importance since 2007 and that country is currently the main foreign investor in Cabo Verde (58.8% in 2017), with Portugal and Spain occupying prominent positions: in the first case, the average of flows since 2001 is around 21%, while in the second case it is around 18%.

Table 8
FDI by countries of origin, 2001-2015 (% of total)

	2000	2002	2004	2006	2008	2010	2012	2014	2016	2017	Average
Ireland	0,0	0,0	0,0	13,2	9,1	14,8	0,7	0,5	-0,1	0,1	3,8
Italy	4,9	73,7	4,3	35,6	4,9	3,1	0,7	0,1	0,7	1,3	12,9
Portugal	79,1	16,3	24,2	18,3	21,3	18,0	13,0	8,3	9,3	5,2	21,3
Spain	0,6	0,0	63,0	60,7	10,8	19,5	3,5	0,8	14,8	6,4	18,0
United Kingdom	1,1	0,0	1,9	12,8	17,0	27,3	39,9	48,5	57,3	58,8	26,5
E. U.	85,7	90,0	93,4	140,7	63,1	82,7	57,8	58,3	82,0	71,7	82,5
Others	14,3	10,0	6,5	-40,7	36,9	17,3	42,2	41,7	18,0	28,3	17,5

Source: Banco de Cabo Verde (www.bcv.cv) and author's own calculations.

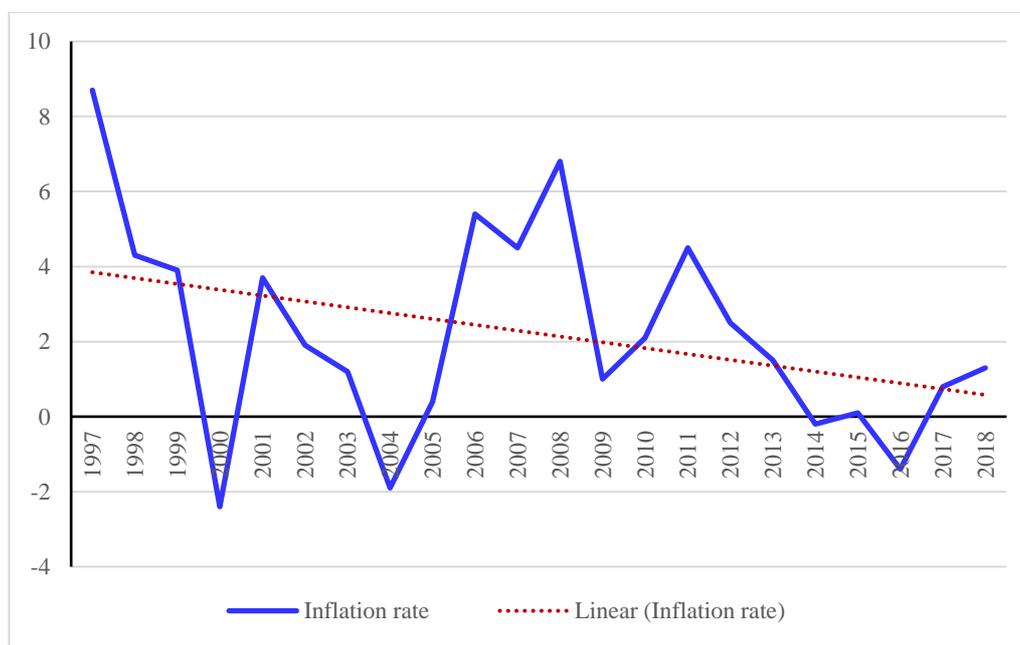
The evolution of trade, remittances and FDI shows the close relationship between the Cape-Verdean and the European economies. That evolution benefitted the foreign exchange stability achieved with the ECA and had significant effects on the Cape-

Verdean economy, both in terms of its stability and the process of change observed since the beginning of the 2000s.

The peg to the euro was an important instrument for influencing price stability (Weber 2005). Given the great weight of imports in the Cape-Verdean economy, the inflation rate of imported goods is a key determinant of the level of domestic inflation. With the ECA, the imported rate of inflation became linked to the inflation rate of the anchor region and Cabo Verde began to directly import the price stability of the European zone, which led to a downward trend in imported inflation and, consequently, in local inflation. Figure 1 shows this downward trend, highlighted by the dotted red line. The volatility of the inflation rate is partly explained by variations in the prices of local goods, which are very dependent on the quality of agricultural years. However, that volatility is also in a downward trend, particularly in the second half of the period under analysis.

Figure 1

Inflation, 12-month average percentage change, 1997-2018

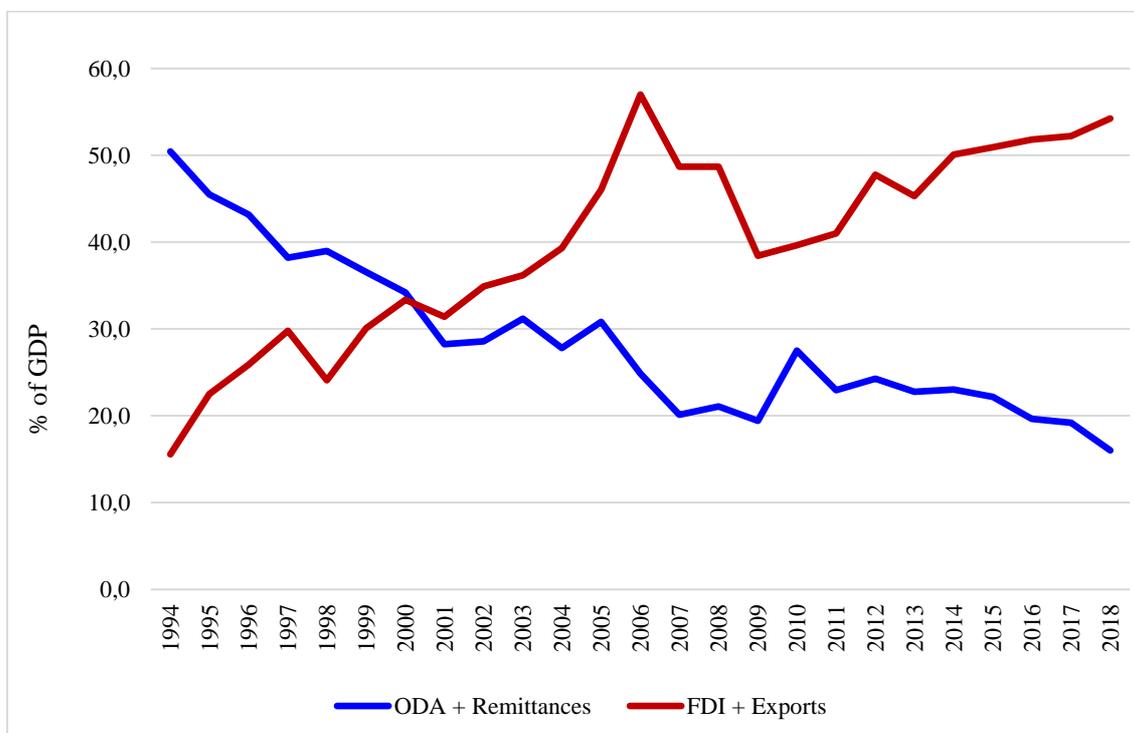


Source: INE, Cabo Verde

The country, with the foreign exchange stability and the growth of financial flows from abroad, progressively recuperated the constitution of international reserves. Therefore, foreign exchange reserves have grown steadily, with a much more comfortable situation today (5 to 6 months of imports) than in the late 1990s, when reserves often represented less than a month of imports.

Globally, the ECA has influenced, in a very significant way, the climate of economic change in Cabo Verde since the early 2000s. That climate has allowed the country to move from a situation where it depended essentially on flows of transfers (private and public) to a situation where the economy is increasingly based on market relations and flows. Figure 2 shows this clearly: up to around 2000, the sum of the official assistance and remittances flows had a much greater weight in the Cape-Verdean economy than the sum of foreign investment flows (insignificant until around 1993) and export revenues. Since then the economy has been increasingly dependent on these flows, which reflects a very important change in its operating model. Now, the Cape-Verdean economy is fundamentally based on market flows and its performance depends more and more on the ability to attract foreign investment and to increase the competitiveness of the exports.

Figure 2
‘ODA+Remittances’ and ‘FDI+Exports’ flows, 1994-2018



Source: World Bank, *World Development Indicators* (<http://databank.worldbank.org>).

FINAL REMARKS

The reading of the two post-colonial monetary transitions allows us to highlight three sets of final notes. Firstly, the impact on the banking and financial system was different in each situation. In the first transition, the banking rupture led to a situation of near monopoly of the central bank and to a system managed administratively and with a weak development level. In the second transition, the process of economic liberalisation led to the autonomy of the role of central bank and to the emergence of the commercial banking activity, progressively expanded and internationalised, even though the largest part of the system is in the possession of the Caixa Geral de Depósitos, a Portuguese State

bank. Trade, exchange and financial mechanisms have progressed rapidly and have reached a significant level of development in the past two decades.

Secondly, as we have seen, the second monetary transition significantly affected the evolution of trade and international investments in Cabo Verde. In the case of trade, the European Union has consolidated its position as Cabo Verde's main partner, while increasing the number of European countries with prominent positions in trade flows. FDI emerged as an important flow within the framework of the exchange agreement with Portugal, having grown significantly in the last decades while, at the same time, its sources are becoming more and more diverse. This expansion of direct investment led to a strong growth of the economy and of exports of services in Cabo Verde.

Finally, the second monetary transition allowed the expansion of a whole group of changes that are the foundation of the recent trend of structural transformation of the Cape-Verdean economy, as it goes from a situation in which its performance was mainly based on dependency flows (official assistance and remittances) to a new situation in which the economy started to mainly depend on market flows, both of trade (exports of goods and services) and investment. This means that the Cape-Verdean economy is consolidating itself as a market economy and that its performance depends more and more on the ability to attract foreign investment and to increase the competitiveness of its exports. This path of the Cape-Verdean economy paved the way for the discussion of the future of the ECA, currently on the Cape-Verdean government's agenda: the deepening of the agreement or the euroisation of the economy? (Imam 2009; Loureiro & Martins & Ribeiro 2009).

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