CURRENCY EQUIVALENTS
Currency unit = São Toméan dobras (Db)
US$1.00 = Db 9,348 (period average 2003)

SYSTEM OF WEIGHTS AND MEASURE METRIC
Metric = US equivalent
1 hectare (ha) = 2.47 acres (a)
1 metric tonne (MT) = 2,205 pounds (lb)

FISCAL YEAR
January 1 – December 31

ABBREVIATIONS AND ACRONYMS

AfDB    African Development Bank
CATAP   Ministry of Agriculture and Fisheries-Training
CIAT    Centro de Investigação Agronómica e Tecnológica
CPU     Contribuição Predial Urbana (Urban Land Tax)
EPSP    Education Policy and Strategy Paper
FIAS    Foreign Investment Advisory Service
GDP     Gross Domestic Product
HIPC    Heavily Indebted Poor Country
HP      Health Policy
IBSTP   International Bank de São Tomé and Príncipe
IDA     International Development Association
IFAD    International Fund for Agricultural Development
IMF     International Monetary Fund
ISP     Instituto Superior Politécnico
IUCAI   Instituto Universitário de Contabilidade e Informática
MDG(s)  Millennium Development Goal(s)
MHP     Minimum Health Package
MoFP    Ministry of Finance and Planning
MTEF    Medium-Term Expenditure Framework
MTs     Metric tonnes
NGO     Non-Governmental Organization
NHDP    National Health Development Plan
OHADA   Organisation Pour l’Harmonisation du Droit des Affaires en Afrique (Organization for the
        Harmonization of Business Law in Africa)
PPIP    Programa de Investimento Público (Public Investment Program)
PRSP    Poverty Reduction Strategy Paper
SP      Strategic Plan
WAEMU   West Africa Economic and Monetary Union

Vice President: Gobind T. Nankani
Country Director: A. David Craig
Sector Director: Paula Donovan
Sector Manager: Robert Blake
Task Team Leader: Dorsati Madani
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This report was prepared by Dorsati Madani and a core team at the Bank: Francois Nankobogo, Ismael Ouedraogo, Gerhard Tschannerl (consultant), Julia Devlin, Carlos Tiny (consultant), Thilakaratna Ranaweera (consultant), Michael Lewin, Simplice Zouhon-Bi (consultant). Logistical support was provided by Steve W. Wan Yan Lun, Faye Harbottle and Glaucia Ferreira.

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SÃO TOMÉ AND PRÍNCIPE
COUNTRY ECONOMIC MEMORANDUM

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EXECUTIVE SUMMARY

Preamble

1. The last Country Economic Memorandum on São Tomé and Príncipe was produced in 1993. It noted the disappointing performance of the São Toméan economy during the 1980s which, though no worse that of many sub-Saharan African economies, was clearly in sharp contrast to the performance of comparable island economies in the Pacific and Indian Oceans. The report also noted that while São Tomé’s natural disadvantages and unfavorable external economic environment were major contributing factors to its poor performance, the authorities’ inability to implement and sustain appropriate stabilization and structural policies was an important additional factor.

2. Against this background, the report’s recommendations emphasized improving economic management, including by implementing reforms to enhance the international competitiveness of the economy, promote private sector growth, and spur human resource development. Bank assistance to São Tomé and Príncipe since then has sought to support programs to help implement these recommendations. The present report assesses the progress made by São Tomé and Príncipe over the past decade, and presents a set of recommendations on policy and institutional changes that might help the economy perform better in the future. This exercise is important, on one hand, in light of the need for good policies with which to pursue the aspirations expressed in the PRSP and, on the other, the need to manage the country’s higher income expected shortly from its oil resources so as to make it the basis of permanent improvement in the lives of its people.

Where Does São Tomé and Príncipe Stand?

3. The Republic of São Tomé and Príncipe with a population of approximately 150,000 inhabitants is among the least developed countries of the world, with a 2003 per capita GNP of US$320 and many social indicators ranging below the sub-Saharan African average. According to the 2001 poverty profile, 54 percent of the population lives below the poverty line, and about 15 percent is extremely poor. São Tomé and Príncipe is also highly indebted and belongs to the Heavily Indebted Poor Countries (HIPC) eligible for debt relief. At the HIPC decision point, the debt-to-GDP ratio stood at more than 640 percent, and the country is now expected to reach its completion point in mid-2006.

4. The structure of the economy is heavily tilted toward the public sector, which made up 67 percent of GDP in 2003. The agriculture sector, notably cocoa production for export purposes, plays a central role for the productive sectors. Diversification is limited.

5. Structural and institutional reforms launched in 1998 have supported a recovery of macroeconomic performance that continued despite some uncertainties related to the elections held in 2001–02. Real GDP growth increased from 1 percent in 1997 to 4.5 percent in 2003, owing mostly to the country’s small but rapidly expanding non-cocoa agriculture sector, as well as growth in construction and tourism. The 12-month inflation rate dropped substantially from
more than 80 percent in December 1997 to 12.6 percent in December 1999 and 9.6 percent in 2003.

6. While economic reforms have begun to alleviate the country’s structural rigidities, macroeconomic performance has not yet had a major impact on GDP per capita. Poverty remains a largely rural phenomenon: 65 percent of the rural population lives below the poverty line and 22 percent below the extreme poverty line. Regional, gender, and rural biases in poverty distribution are also evident from the survey data.

7. In addition to poverty, the country faces other development challenges, related in part to its status as a small island economy. These include high vulnerability to external shocks; the inability to exploit economies of scale in the provision of infrastructure, services, and economic activities; a limited export base; low human capacity; and a weak private sector. The country’s large public sector furthermore is characterized by weak institutional capacity, an inadequate legal and regulatory framework, and limited financial resources, making the functioning of the economy and the management of public resources difficult. Moreover, São Tomé and Príncipe is potentially at the cusp of a major economic change, with production of offshore oil expected to start in 2008-10.

The Growth and Poverty Reduction Strategy

8. Faced with the challenges outlined above, the Poverty Reduction Strategy Paper (PRSP) adopted by the Government in December 2002 appropriately emphasizes the need to:
(i) stimulate economic growth, by promoting broad-based private sector activities in the agricultural sector and tourism; (ii) create opportunities to increase and diversify income; (iii) develop access to basic social services, notably in education and health; and (iv) reform public institutions, build capacity, and promote good governance. To foster broad-based, private sector driven growth and poverty alleviation, the present study identifies also four overarching priority areas that match the PRSP strategic vision: (i) to provide an adequate business environment; (ii) to enhance support to the social sectors; (iii) to continue economic management reforms; and (iv) to push ahead with the strengthening of governance and with the building of institutional capacity. Annex V summarizes the policy and action plans suggested in these areas.

1. Engendering Private Sector-Led Growth

9. The private sector is small, weak, and composed mostly of informal micro-enterprises, with a few mid-sized and large formal firms. In general it lacks business experience and exposure to regional and global markets. The sector is constrained also by the lack of a business-friendly fiscal environment, credit, and markets; by the relative lack of institutional support, and by a weak legal framework. To engender private sector-led growth, the following prioritized measures need to be taken in the short term: (i) a legal and regulatory business framework must be established; (ii) an appropriate fiscal framework for private sector activity must be established; and (iii) the financial sector must become more responsive to private sector development (PSD) needs. In the medium term: (i) the active participation of the government in the economy must be reduced; and (ii) the country’s infrastructure must be rehabilitated or built.
10. **The country lacks a legal business framework.** Contract enforcement, dispute resolution and property rights are weak. Debt and asset recovery is difficult. Adoption of the regional business legal framework from the Organization for the Harmonization of Business Law in Africa (OHADA) should provide the country with the framework it needs; in the meantime, the Directorate of Commerce and Industry should refocus its efforts on development and implementation of policies fostering private sector growth instead of fee collection. In the agriculture sector, a major priority is new land legislation, including the proper registration of cadastres, usufruct titles, inheritance, and rental, to remove uncertainty regarding land tenure rights and use. The government needs also to simplify the land title registration process, to register nationalized lands, and to take greater control of forest use. The scope of the legal authority and responsibility of villages and dependencies, as well as structures that are collectively owned needs to be defined.

11. **The fiscal environment for private sector development is slowly becoming more business friendly, but further reforms are needed.** Private sector competitiveness would be improved by a streamlined administration and a simplified tax code rationalizing tax types and rates and minimizing exemptions. The government will soon present a new tax code to the National Assembly, developed in the first half of 2003. The draft proposes to reduce income tax rates to 25 percent, eliminate the urban land tax and the minimum value tax. The government additionally should consider rationalizing the licensing and registration procedures and eliminate "alvaras". The new tax code should be promulgated as soon as possible, especially as it incorporates the new foreign investment code which provides a simplified and accessible set of rules for investors compared to the 1992 code. However, it could be strengthened further if the government were to clarify the expropriation clause of the law and the list of excluded sectors. Additionally, the government will need to undertake a cost-benefit analysis of the clause providing the land and building concessions to investors to ascertain the benefits to the country of these incentives. It is unclear whether an export processing law is needed, given the nature of the new tax code incentives.

12. **Small and medium-sized enterprises (SMEs) and micro-enterprises are severely constrained by lack of access to formal sources of credit.** São Tomé and Príncipe has no formal savings associations and the micro finance system is embryonic. The government supports the establishment of more private banks, but there is need also to develop a micro credit infrastructure. This process would require: (i) the adoption and application of legal status to the credit institution, (ii) the definition of homogeneous financial rules across all such institutions, and (iii) the integration of the micro credit chain into the national banking system through revision of the banking laws. To ensure proper regulatory and financial oversight of micro credit institutions, government efforts should be coordinated closely with those of the non-governmental organizations (NGOs) and donors that can provide the start-up funds for the system and technical assistance in training the management teams.

13. **The government's activities should aim at reducing its active role in the productive sectors and overcoming rigidities in the labor markets.** The slow and incomplete privatization process has inhibited private sector engagement in industry and agriculture. The government should: (i) review the privatization process including by analyzing the efficiency gains of the process and its social and poverty impact; (ii) it should reformulate the policy to better suit the country's conditions and needs; and (iii) it should reinvigorate the process with a new action.
plan, tied to a clear timetable. It also should take concurrent steps to mitigate the negative
effects of land reform on the environment and immigration.

14. Centralized wage setting and public sector pay awards, a result in part of the influence of
strong civil service unions, have helped create rigidities in the labor market. The ongoing civil
service and public sector reforms should consider alternative employment and wage setting
formulae, such as the use of performance bonuses, to create a more competitive, flexible, and
efficiency-oriented structure in the sector and by extension in the economy as a whole.

15. Transport and infrastructure limitations reduce the effective size of markets and the
potential of existing businesses, and discourage new investors. The condition of secondary and
feeder roads in São Tomé and Príncipe is poor. In addition, there is no systematic, well-funded,
and unified national road maintenance program as funds are largely provided by international
partners. For its 2004–06 program, the government may wish to consider improving the
management of the Road Fund such that it can become the main source (and possibly the only
source) of funding for road maintenance. Investment should prioritize the maintenance,
rehabilitation, and construction of rural roads; the reconstruction of trunk roads to isolated areas;
and the upgrading of existing roads.

16. The low frequency and high costs of air services and poor airport infrastructure are
significant barriers to the country’s development. The airport reception and landing strip need
modernization to accommodate the expected growth of tourism and transportation services
exports and non-traditional exports forecast in the PRSP. The commencement of offshore oil
production will put further pressure on the country’s air transportation system. The government,
which plans to establish an open sky policy, needs to redraw the legal and regulatory framework
in the sector and privatize Air São Tomé. It should encourage foreign private investment or
should seek foreign aid to extend and upgrade the airport (costs are estimated at US$20-25
million), and should contract out management of the new airport to the private sector.

17. The port infrastructure, comprising small, obsolete quays of shallow depth and using
dilapidated equipment and irregular sea services prevents the full integration of the country into
regional and global markets, impeding economic diversification. The priorities in this area are
the preparation of a study on the cost of building a deep-sea port and some immediate
improvements to the port and port services. These latter include to: (i) simplify and lower the fee
structure; (ii) retain port revenues for capital investments and maintenance of the port
infrastructure; (iii) institute a scheduled and reliable service to Príncipe to be operated by the
private sector on a competitive basis (if necessary, with a subsidy); and (iv) separate the
passenger terminal from the freight terminal to reduce theft and lower the risk of accidents. In
the medium term, the port authority should be made an autonomous entity, with parts of the port
operation opened up to the private sector on a competitive basis to encourage better pricing.

18. Investments in selected infrastructure could stimulate additional supply. State
intervention is warranted in certain key areas of marketing infrastructure to encourage the growth
of private sector enterprise. For example, development of the perishable food industry,
particularly exports of fresh fruits and vegetables, will require the building of cold chains, of in-
field packing centers and central market and export terminal cold rooms. In the case of artisanal
fishing, the priority is cold storage, requiring the provision of ice-making equipment and cold
storage rooms at key locations. In addition to marketing infrastructure, electricity supply, telecommunications, water, and sanitation all need to be improved (Annex III).

2. **Enhancing Support to the Social Sector**

19. Human resource development is a central priority to the economic growth and poverty alleviation strategy of São Tomé and Príncipe: a healthier and better educated population is a more productive and a better paid one.

(a) **Health**

20. The prevalence of malaria, which affects some 80 percent of the population, is the priority health issue in São Tomé and Príncipe. While health coverage is high, the quality of service is low. The health infrastructure is aging, there are serious shortcomings in technical staffing and management, there is the problem of expenditure misallocation, and there is an absence of national policies for provision of drugs and for the acquisition and maintenance of health technologies. While the per capita expenditure in health was in 1999 a relatively high US$30 health budgeting has had an ad hoc nature, defined as it is by the availability of funds.

21. The government embarked in 1999 on a reform of the health sector, and has developed a Health Policy (HP), a National Health Development Plan (NHDP), and a *carta sanitária* (health infrastructure chart). The health sector is a focal point of the PRSP, but although the NHDP and HP match the PRSP goals neither mention the millennium development goals to which the country subscribes. The only quantitative health objective identified in the PRSP is that the share of health expenditure in the government budget should remain at 13 percent through 2005–2015. This goal is already achieved since 1999. There also is a need for closer coordination of the program goals to strike a balance between the country’s needs and what is feasible in the medium term, given the financial and human resource constraints.

22. The PRSP health targets urgently need to be completed and finalized in order to operationalize a comprehensive strategy for their attainment. It would be useful for the authorities to unify and prioritize the goals stated in the HP, NHDP, the PRSP health targets and the millennium development goals in health. The government needs to implement its national strategies for malaria and AIDS; and needs also to define and adopt a pharmaceutical policy. The NHDP should emphasize clearly the minimum health package (MHP) as a strategy to bring health care to every citizen. Finally, the sector needs a more thorough policy for human resource management to ensure that the goals of the HP—systematic training, professional development, and better salary structure—are achieved. A special emphasis needs to be placed on strengthening managerial capacity in the sector.

(b) **Education**

23. The education sector’s institutions and infrastructure have been seriously affected by the country’s long-term economic decline. On average, students only receive two to four hours of learning time per day, and education policies have to date addressed neither gender nor poverty issues. Institutions, planning, administration, monitoring, and evaluation are weak. Teacher retention has been poor due to low motivation, training, and salaries, and the system has very low internal productivity, with poor student retention rates, and high repetition rates. Access to
the educational system and the quality of the system both need major improvement. Finally, expenditure misallocation and insufficient investment in infrastructure, despite large donor support, mean that the educational system has been unable to keep up with demand and use.

24. The reform process of education is less advanced than that of the health sector. The government adopted a new educational structure in 2000, but lack of finances and capacity mean that it has not yet implemented the changes. An Education Policy and Strategy Paper (EPSP) and a Strategic Plan (SP) have been developed, but while the latter incorporates the millennium development and “Education for All” goals it does not seem well coordinated with the PRSP.

25. The education strategy has been finalized and costed for realism given the country’s resource constraints. However, it still needs to be adopted and implemented and must fit in with the PRSP educational goals, including the Millennium Development Goal (MDG) on gender equality. The carta escolar (school mapping) should be adopted. Institutional reform should include extensive capacity building at the managerial (management, planning, and evaluation) and teaching levels to improve the efficacy of the system, and management should be decentralized and partnerships strengthened with municipalities, parents, communities, and NGOs. The SP needs to provide a plan of action and costing for a cogent overall approach to meeting training needs. Finally, while basic education is identified in the PRSP as the priority, it is important that education also responds to the demands of the market: specifically, to address high youth unemployment with more secondary technical and professional education.

3. Continuing the Economic Management Reforms

26. The inability to sustain economic management reforms has hampered the progress of the São Toméan economy over the past decade. The weaknesses in the macroeconomy, particularly in public finances, are severe and have amplified the instability already inherent in the small size of the economy. A major improvement is needed in this area as precondition for sustainable growth and poverty reduction.

27. In-depth reform is needed on the formulation, execution, and monitoring of the budget, to increase efficiency and transparency of the public sector in view of the desire for private sector-led growth and the expectation of potentially large future petroleum earnings. The yearly formulation of the budget would benefit by the adoption of a medium-term (three to five year) expenditure framework, which would help the government program its budgetary and project aid flow more efficiently. The Public Investment Program (PIP) budgeting process additionally should be reviewed to ensure fuller coordination with budget nomenclatures, with PRSP goals and priority actions and with donors. Accounting for budget execution is weak and there is need to create a double ledger accounting program that would modernize the practices of the directorate and consolidate all fiscal data. Monitoring of public expenditure also is inadequate, as there is only ad hoc a priori internal control of the budgetary process (fiscal and financial) and there is no ex-post intervention. One suggested improvement would be to incorporate systematic a priori financial control after credit approval and before making an expenditure commitment. Strengthening the nascent office of the Lead Public Finance Auditor with financial verification training also would improve ex post financial control. Finally, the national assembly should oversee the budget execution performance for which it gives its annual approval.
The onset of the petroleum era will bring new challenges in public finance management, governance and macroeconomic discipline. Already signature bonuses are expected on petroleum contracts in early 2005 and a steady revenue flow is expected to start in 2008-2010 if oil is struck and production begins. São Tomé and Príncipe lacks the policy and legal frameworks and the institutional and technical capacities to manage the emersion of a major sector.

In anticipation of this fundamental economic change the Government has established the basic legal and institutional structures for the supervision, regulation and management of the sector and its revenues in early 2004. To this end, a National Petroleum Committee was created to oversee the sectoral policy and a National Petroleum Agency was created to provide economic, technical and legal analysis for the sector. The Government has also developed a petroleum revenue law that includes strong elements of transparency and the use of a savings funds. This law is to be presented to the National Assembly in the summer of 2004 for discussion and adoption. However, from a public management perspective and given the country's lack of capacity, it needs to take three urgent actions to prepare for the future revenue influx: (i) undertake economic analysis and alternative projections of the petroleum revenue influx and its potential impact on the economy to inform the government about budgetary and macroeconomic policy choices, including those related to the use of a savings fund; (ii) develop a Petroleum sector strategy; and (iii) undertake comprehensive and multi-faceted capacity building in the Petroleum Authority, other fiscal agencies within the government, and the national assembly (covering legal, economic, technical and management policies). In the short term, the most acute training needs are concentrated in the legal and technical fields.

Strengthening Governance and Building Institutional Capacity

Governance issues directly affect growth as weak governance hampers the ability of economic agents to function within a clear policy environment. In this respect, current low technical administrative capital does not permit the proper formulation, implementation, and follow-up. The administrative reforms of the Ministries of Finance, Health, and Education and the new petroleum-related capacity also have exposed a need for targeted training and capacity building, which should be undertaken based on a ministerial-level strategic approach to strengthen public sector capacity. Such an approach would also provide a structure supporting donor commitments through the medium term.

The public sector's low and highly compressed remuneration packages and its outdated professional categorizations damage the efficiency of public administration by creating a culture of low work incentive and high absenteeism. Civil sector employment categories and salary scales are being restructured and redefined, and in the past three years the civil service has been downsized and wages increased. Further performance-based bonuses applied to a base salary could engender incentive and efficiency gains while avoiding the budgetary pressure of large, across-the-board wage increases.

The judicial and regulatory system—the lever to provide administrative and institutional validity to the government's rule of law—faces a number of critical issues. The antiquated
commercial, penal, and civil codes of the legal framework require updating (some date back to 1869), and the expediency and quality of judicial services is jeopardized by a lack of qualified professionals, by influence peddling, by inappropriate use of information, and at times by bribery. The government needs to accelerate its efforts in this domain. It has reviewed its petroleum contracts to ascertain their economic effect and has renegotiated them. It also has elected to liberalize the country's telecommunications, promulgated a legal framework to this end in 2003 and has established a regulatory unit to oversee the negotiations and activities connected with the future liberalization of all other utilities. The ministry of justice is developing a plan for legal and structural reforms and capacity building, prioritizing over the next three years the updating of labor, family, penal, and civil law and the administrative codes and laws that protect minors. The plans for the reform of judicial institutions and for capacity building nonetheless need to be expedited, as does the strengthening of the nascent judicial inspection process.

What Lies Ahead?

33. It is clear that the government is committed to its private-sector-led growth and poverty reduction strategy. Ultimately, its success will be conditional on its ability to redefine its role in the economy—on its success in retreating from economic activities while undertaking the necessary reforms and providing the basic legal, business, infrastructural, and institutional framework within which the private sector can flourish.
1. INTRODUCTION

1. The last Country Economic Memorandum on São Tomé and Príncipe was produced in 1993. It noted the disappointing performance of the São Toméan economy during the 1980s which, though no worse that of many sub-Saharan African economies, was clearly below the performance of comparable island economies in the Pacific and Indian Oceans. The report also noted that while São Tomé and Príncipe’s natural disadvantages and unfavorable external economic environment were major contributing factors to its poor performance, the authorities’ inability to implement and sustain appropriate stabilization and structural policies were an important additional factor.

2. Against this background, the report’s recommendations emphasized improving economic management, including implementing reforms to enhance the international competitiveness of the economy, promote private sector growth, and spur human resource development. Bank assistance to São Tomé and Príncipe since then has sought to support the implementation of these recommendations. The present report assesses the progress made by São Tomé and Príncipe over the past decade, and presents a set of recommendations on policy and institutional change that might help the economy perform better in the future.¹ This exercise is important, on one hand, in light of the need for good policies with which to pursue the aspirations expressed in the PRSP, and, on the other, the need to manage country’s higher income expected shortly from its oil resources so as to make it the basis of permanent improvement in the lives of its people.

3. The Democratic Republic of São Tomé and Príncipe is an archipelago of two small tropical islands 400 kilometers west of Gabon. With a land area of 1,001 square kilometers it is the second smallest country in Africa after the Seychelles. The islands are endowed with a number of microclimates, and a rich endemic fauna and flora thrive in what are the second most important of Africa’s 75 primary forests. São Tomé and Príncipe has all the handicaps of a small island economy, but has not yet begun to turn its locational advantages into a source of progress for its people.

4. The country’s population in 2003 was approximately 150,000, growing at 1.8 percent per year.² The population density is 150 per square kilometer. Urbanization is accelerating: in 1992, 44 percent of the population lived in urban areas; by 2001 this number had reached 55.6 percent.³ The capital city, São Tomé, is located on São Tomé Island and houses an estimated 50,000 inhabitants. Príncipe has one small town and a total of about 7,000 inhabitants.

5. São Tomé and Príncipe is designated a least developed country, with an estimated GDP of US$59.6 million in 2003 and a predicted GDP of US$62.2 million in 2004. It reached the decision point under the Highly Indebted Poor Country (HIPC) Initiative in December 2000, with a debt-to-GDP ratio of more than 600 percent. The public sector dominates the economy,

¹ The report data is up to end 2003.
² 2000 population survey. The population is of mixed ancestry, and consists of the Forros (mix of European colonists and African laborers), the Angolares (descendents of former Angolan indentured workers), and Cape Verdeans who migrated to the islands in the late 19th and early 20th centuries.
with the ratio of public expenditure to GDP reaching 67.3 percent in 2003. The private sector is small, weak, and mostly informal. The productive structure of the economy has not altered significantly in the past three decades: the agricultural sector is a main contributor to GDP, with cocoa production and export a central feature of the economy. Despite its good soils and favorable climate, this heavy emphasis on export-oriented plantation agriculture means that the country imports more than two-thirds of its foodstuff.

6. São Tomé and Príncipe experienced a long decline in economic performance since achieving independence in 1975. The principal factor for the country's economic deterioration was the high cost of labor affecting the profitability of the cocoa sub-sector and entrenching a structural crisis in the plantation based economy. The socialist policies implemented during the first 10 years following independence and the departure of skilled human resources also contributed to the country's economic difficulties. From 1987 to 1997, the economic and financial crisis was profound. An early attempt to staunch the crisis was made in 1990 when São Tomé and Príncipe, with the support of the donor community, embarked upon an ambitious recovery and economic development program. The results were poor, due mainly to weak institutional capacity, the lack of adequately skilled human resources, and adverse external shocks (especially the decline in world cocoa prices), compounded by a heavy reliance on aging and diseased cocoa plantations. Real GDP growth rates remained low, macroeconomic imbalances worsened, unemployment increased, and living conditions deteriorated. Annual real GDP growth rate averaged about 1.6 percent over this period, despite an average investment rate of 36 percent of GDP signifying the low productivity of capital spending. Income per capita decreased from US$350 in 1987 to US$330 in 1993-1995 period, and about US$300 in 1997.

7. Poverty worsened in the period up to the year 2000. In 1994, the proportion of the poor exceeded 40 percent of the population. This situation deteriorated through the remainder of the 1990s, when economic and social conditions worsened and a sizable external debt was accumulated. By the year 2000, 53.8 percent of the population was classified as poor. The United Nations Human Development Report (2002) placed São Tomé and Príncipe 123 of 177 countries ranked.

8. In 1998–99, the government launched its most recent and most extensive economic reform program, assisted by the World Bank and the International Monetary Fund (IMF). Many of the reforms are continuing and their results have been broadly satisfactory. Growth has picked up since 2001 while inflation has been generally kept in check. In 2001 GDP grew by 4 percent and inflation reached 9.5 percent. The 2002 performance mirrored that of 2001: GDP grew by 4.1 percent and inflation was further contained at 9.2 percent. Growth reached 4.5 percent in 2003, while inflation rose to 10.2 percent. Income per capita has bounced back from US$300 in 1997 to approximately US$320 in 2003.

9. Despite this progress in macroeconomic stabilization, poverty is still widespread and severe, and the country faces serious development challenges. Its size, location, narrow production base, and small population mean that it faces the common handicaps of a small island economy: high vulnerability to external shocks, the inability to pursue economies of scale, lack of basic infrastructure and services, low human capacity, and a weak private sector. To compound these development challenges, the country's large public sector is characterized by weak institutional capacity, limited financial resources, and uncoordinated and unreliable donor
flows, making the functioning of the economy and the management of public resources difficult. The islands potentially are at the cusp of major economic changes, however, with offshore oil production expected to begin in 2008-10.

10. The government finalized a Poverty Reduction Strategy Paper (PRSP) in December 2002 that outlines a strategy to foster a diversified, private-sector-driven economy. The implementation of such a strategy would entail creating a business and institutional environment that provides an adequate regulatory and institutional framework and that avoids distorting economic incentives. For São Tomé and Príncipe, this would require continued reforms and capacity building in the legal and institutional arena, the social sector, and the real economy.

11. Chapter 2 of the CEM reviews São Tomé and Príncipe’s recent reform and policy initiatives, its macroeconomic and sectoral performance, and the effectiveness of public policy during the late 1990s. Chapter 3 outlines the constraints to private-sector-led growth. It also analyses the two sectoral sources that hold the most promise for economic diversification: agriculture and tourism. Chapter 4 examines the main economic development challenges the country faces in achieving growth and poverty alleviation: human resource development, economic management, continued institutional reforms, and capacity building. It provides medium-term recommendations for policy reforms to underpin the process of efficient and sustained growth and poverty reduction. In Chapter 5, macroeconomic projections provide an indication of São Tomé’s medium-term prospects.

<table>
<thead>
<tr>
<th>Table 1.1: Economic and Social Indicators</th>
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<td>125</td>
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<tr>
<td>Population growth (2003)</td>
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<tr>
<td>GNP (US$ millions) (2003)</td>
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<td>GNP per capita (2003)</td>
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<tr>
<td>GDP growth (2003)</td>
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<tr>
<td>Fiscal deficit (2003)</td>
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<tr>
<td>Inflation (CPI period average) (2003)</td>
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<td>Export growth (2003)</td>
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<tr>
<td>Population living &lt;US$1/day (2000)</td>
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<tr>
<td>Literacy rate (% pop. age 15+) (1999)</td>
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<td>net primary enrollment (2003)</td>
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<tr>
<td>Infant mortality rate (per 1,000 live births) (2000)</td>
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<tr>
<td>Life expectancy at birth (years) (2000)</td>
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<tr>
<td>Child malnutrition (1996)</td>
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<tr>
<td>Prevalence of HIV/AIDS (2001)</td>
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</table>
Box 1.1: Political History

Portuguese colonists settled in São Tomé and Príncipe in 1493. Using imported Angolan slave labor, they had turned the islands into the world’s largest sugar producer by the mid-16th century. By the 19th century, coffee and cocoa production had become the islands’ dominant export commodities. Independence was declared on July 12, 1975, with Mr. Pinto da Costa as first president and Mr. Trovoada as prime minister. Transition to a socialist system was almost immediate.

In 1985, Mr. Pinto da Costa began a gradual introduction of political and economic reforms to countermand the serious economic deterioration that the country had been experiencing since independence. A democratic constitution was introduced and the first multiparty parliamentary elections were held in January 1991. Mr. Trovoada was elected president in March 1991.

Since 1991, São Tomé and Príncipe has enjoyed a democratic political system. Nonetheless, political life has been marked by instability and administrative deadlock, punctuated by differences between the office of the presidency and succeessive governments, internal party discords, governance issues, and in 1995 a brief coup. In 1996 Mr. Trovoada was elected as president for a second term and political life stabilized relatively under the new reform-minded prime minister, Mr. Possi de Costa, and a political cohabitation agreement between the government and the president.

The July 2001 presidential election led to the victory of Mr. Fradique de Mendes, but has not resolved the inherent instability of the political system. Between July 2001 and September 2004, the country experienced six government changes. Failing to reach a cohabitation agreement with the majority party (the MLSTP-PSD), the new president convened a presidential initiative government and called for legislative elections for March 3, 2002. The elections resulted in the formation of a short-lived coalition government led by Mr. Gabriel Costa. In September 2002, a second coalition government was formed under the leadership of the first woman prime minister, Ms. das Neves. This latest coalition government experienced a July 2003 bloodless coup and underwent two further ministerial reshuffling before being dismissed by the President in September 2004. A new coalition government was immediately sworn in under the leadership of Mr. Vaz d’Almeida, of the MLSTP/PSD.

International Relations. São Tomé and Príncipe maintains close relations with Angola, France, Portugal, and Taiwan Province of China. With the advent of the petroleum era, several other countries, including the United States and Brazil, have established diplomatic relations. It joined the Organization of African Unity (OAU) after 1975 signed the Lomé Convention in 1977, and was a founding member of the Communauté Économique des États de l’Afrique Centrale (CÉAC) in 1983. In 1996 the country became a member of the Communidade dos Paises de Lingua Portuguesa (CPLP), and in 1997, the Organisation de la Francophonie. Voice of America has a radio-relay station on São Tomé island. The country is also part of the Central African Regional Organization and is considering joining the CFA zone.
2. RECENT REFORMS AND MAIN ECONOMIC DEVELOPMENTS

A. Recent Reforms

12. São Tomé's authorities have made efforts at various times to implement reforms, but these have often not been complete enough to elicit sustained improved performance of the economy. During the 1990s, São Tomé undertook several structural reforms within the framework of programs with the IMF and the World Bank. It liberalized the economy and reduced the role of the government in productive activities. In particular, it contracted out the management of its agricultural public estates to private operators under long-term leases; restructured the banking system, with the separation of commercial bank functions from those of the central bank and the establishment of two private banks in 1993 and 1995, respectively; liberalized pricing; and introduced a floating exchange rate at the end of 1994. Reforms in the fiscal area needed to strengthen the macroeconomic environment as a complement to structural reforms were not forthcoming owing to lack of political commitment. As a result, the economy performed poorly through 1997, with significant macroeconomic imbalances and deteriorating social indicators.

13. The authorities in 1998–99 implemented a series of reforms within the framework of an IMF staff-monitored program. The reforms focused on consolidating the public finances, through improving the administration of both direct and indirect taxes and some restraint in expenditure. The combination was to improve the public finances which together with rigor in monetary policy was to result in a stabilized exchange rate, and lower inflation. The macroeconomic measures were accompanied by good progress on plans for structural reforms: a timetable for civil service retrenchments was established; a new public enterprise reform and privatization program was adopted; and an administrative unit for the oil sector was created.

Box 2.1: Policy Reforms of the 1990s

In order to broaden the role of markets in resource allocation, price controls were eliminated; domestic trade, including the marketing of agricultural products, was completely liberalized; and a mechanism was introduced to automatically adjust petroleum retail product prices in line with changes in international prices.

In the area of institutional development, the government adopted new organizational and staffing plans for each of its 10 ministries, and revised civil service regulations.

As part of a public enterprise sector reform and private sector development program, the bankrupt national savings and loans institution (CNPC) was liquidated and a loan recovery program established; the petroleum distribution company (ENCO) was partially privatized and two hotels were placed under private management; a law governing property rights was adopted that clarifies the exercise of ownership rights; and work was begun to prepare a strategy for privatizing government-owned agricultural estates and rationalizing the land tenure system.

In the area of trade and exchange, the export receipts surrender requirement was eliminated. All non-tariff import barriers were removed and external current account transactions were liberalized. Further, the tariff structure was simplified to three bands (5, 10, and 20 percent), conforming to the West Africa Economic and Monetary Union (WAEMU) common external tariff levels. With these reforms, the index of trade policy restrictiveness fell from 10 in 1997–98 to 5 in 1999. The exchange rate has been officially free floating since 1994.
14. Building on the progress made during 1998–99, the authorities embarked in April 2000 on a new medium-term program. In the macroeconomic sphere, the program included measures to broaden the tax base, by upgrading the tax roll and eliminating losses at customs due to ad hoc exemptions; making operational the computer (SYDONIA) system installed at customs; and by sharpening the focus of expenditures on priority sectors and improving sector strategies and project selection in the area of capital expenditure. The structural measures planned included further price and trade liberalization; progress on public enterprise reform and privatization, with the centerpiece as the divestiture of the large government agricultural estates; pursuit of planning civil service reform, through identification of redundant staff positions and assessment of retrenchments; and introduction of governance measures centered mainly around the auditing of the accounts of various public entities. In view of the improved track record under the SMP, the new program was supported by the IMF under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement. It also received the support of the World Bank, the European Union, and the African Development Bank. The program emphasized public sector reform, downsizing of the civil service, and capacity building.

15. As with most of the programs of the 1990s, this new program experienced slippages, when political deadlock led to administrative stalemate and slowed the pace of the reform process, following the July 2001 presidential election. As a result, IMF support under the PRGF was suspended and another IMF Staff Monitored Program (SMP) was launched in January 2002. Owing to budgetary slippages (which have been attributed to the March 2002 legislative elections), performance under the SMP failed to meet the targets, and the SMP was off-track up to June 2002. The SMP was extended to end-2002, as the government returned to fiscal discipline and expenditures were curbed. By the end of the year 2002, São Tomé’s reform track progress was judged broadly satisfactory. On this basis, in July 2003 the authorities entered discussions with the IMF on a program that could be supported with a new 3-year PRGF agreement. The July 2003 bloodless coup postponed reaching an agreement as the government was busy addressing social and economic demands by the military and the civil service. While the SMP expired, the government managed the macroeconomic developments such that the country performance was deemed broadly satisfactory for 2003 by the IMF.

B. Macroeconomic Performance

1. Real GDP Growth and Prices

16. In line with the ebb and flow of the reforms, macroeconomic performance only strengthened after 1998. Real GDP grew from an average of 1 percent over 1985–97 to 3 percent in 1999-2000. This performance occurred while in 1998–2000 the country experienced three adverse external shocks: cocoa output dropped by 13 percent due to production problems and plant infestation, world cocoa prices fell sharply, and import prices for petroleum products tripled. Nevertheless, as progress in economic reforms began to alleviate structural rigidities, the impact of the decline in cocoa production was more than offset by the small but rapidly

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expanding non-cocoa agriculture, construction, and tourism, which constituted the major sources of growth.

17. Real GDP growth accelerated further and reached an average of 4 percent in 2001-02 and 4.5 percent in 2003 with moderate inflation. Inflation dynamics were driven by the successful implementation of demand management policies, and the inflation rate dropped substantially from more than 80 percent in December 1997 to 12.6 percent at end-1999 and further to 9.2 percent in 2002. In 2003, the increase in energy prices, post-coup social spending and the civil service salary increase contributed to a slight rise to 9.6 percent.

2. Budget and Public Finance

18. Along with higher real GDP growth and reduced inflation, fiscal discipline improved during the adjustment period 1998–2000. The greater discipline and restraint in issuing central bank credit to the government led to a reduction in total expenditure from 70.1 percent of GDP in 1997 to 66.1 in 2000. The overall fiscal deficit was reduced from 26.7 percent in 1997 to 16.5 percent in 2000, while the primary budget balance (excluding grants and foreign-financed investments) switched from a deficit averaging 3.5 percent over 1996–97 to a surplus averaging 1.7 percent in 1999-2000.

19. Reduction of the deficit reflected the improved performance of tax revenue, which rose from 10.6 percent of GDP in 1997 to 16 percent in 2000 as a result of tax and customs reforms. Improved demand management policies, including curbs in public spending and reduced government use of domestic banking system credit also contributed to improving the overall fiscal outcome. The deficit was financed primarily by loans on concessional terms. Domestic and external arrears were reduced each year since 1999.

20. A reversal of policies occurred in 2001 when fiscal discipline weakened in the wake of presidential elections. Spending overruns were triggered by petroleum contract bonuses, elections-related expenditures, a public sector salary increase estimated at 25 percent, and a loan to the public energy company to keep it afloat during its restructuring process. The primary budget balance (including HIPC expenditure) turned into a deficit of 12.9 percent), and the overall fiscal deficit increased to 20 percent of GDP despite an increase in tax revenue to 18.3 percent of GDP due to improved collection. The implementation of structural reforms (civil service reform and privatization programs) was also delayed due to weak institutional capacity and governance issues in the oil sector, compounded with a lengthy election process and political deadlock. As a consequence of these slippages, the macroeconomic program agreed with the IMF and World Bank went off track.

21. The budgetary slippages continued in the first quarter of 2002 with deficit financing of large expenditures related to the March legislative election and the launch of a government-sponsored transport and nutrition program for school children. The primary fiscal deficit reached -8.4 billion dobras for the quarter, exceeding the agreed deficit level in the IMF SMP of -1.8

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5 The wage bill is estimated at 9.6 percent of GDP in 2001 compared to 7.8 percent in 2000 (IMF, 2004).
The government managed to keep the line on the wage bill (9 percent of GDP compared to 9.6 percent in 2001) and fiscal discipline improved again in the second half of 2002, leading to a primary budget balance (including HIPC expenditure) of -4.3 percent for the year versus the -0.1 percent of GDP predicted by the SMP.

22. The budgetary performance during the first half of 2003 led to an overall satisfactory macroframework, with the primary balance (including HIPC expenditure) at -3.4 percent of GDP and the overall balance at -4.5 percent of GDP. The major concern focused on higher than expected government current expenditures in energy and telecommunications, highlighting the monopoly nature and the inefficient cost structure of both sub-sectors. Slow release of international funds (grants and loans) caused delays in capital expenditures. The July 2003 Coup led the government to increase social expenditures and the wage bill to allay social tensions. By end year, the primary balance reached -11.8 percent of GDP and the overall balance reached -17.2 percent of GDP. The wage bill rise to 9.9 percent of GDP. Despite these socio-politically driven expenditures considered the macroeconomic framework was deemed overall satisfactory by the IMF.

Table 2.1: Government Budget (as percentage of GDP): 1997–2003

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<tbody>
<tr>
<td>Total revenue and grants</td>
<td>43.4</td>
<td>29.1</td>
<td>43.9</td>
<td>49.6</td>
<td>59.3</td>
<td>50.3</td>
<td>50.0</td>
</tr>
<tr>
<td>Of which: grants</td>
<td>27.8</td>
<td>9.7</td>
<td>24.6</td>
<td>28.0</td>
<td>37.8</td>
<td>27.0</td>
<td>24.6</td>
</tr>
<tr>
<td>Total expenditure</td>
<td>70.1</td>
<td>59.6</td>
<td>69.8</td>
<td>66.1</td>
<td>78.9</td>
<td>64.1</td>
<td>67.3</td>
</tr>
<tr>
<td>Of which: non-interest current expenditure</td>
<td>16.6</td>
<td>16.3</td>
<td>15.8</td>
<td>17.6</td>
<td>23.0</td>
<td>20.5</td>
<td>28.2</td>
</tr>
<tr>
<td>Overall balance (commit. basis, including grants)</td>
<td>-26.7</td>
<td>-30.5</td>
<td>-25.9</td>
<td>-16.5</td>
<td>-20.0</td>
<td>-17.8</td>
<td>-17.2</td>
</tr>
<tr>
<td>Overall balance (commit. basis, excl. grants)</td>
<td>-50.5</td>
<td>-44.5</td>
<td>-55.1</td>
<td>-40.8</td>
<td>-41.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Primary balance (commitment basis)</td>
<td>-2.2</td>
<td>0.7</td>
<td>1.3</td>
<td>2.1</td>
<td>-12.9</td>
<td>-4.3</td>
<td>-11.8</td>
</tr>
<tr>
<td>Primary balance (commit basis; excl. HIPC Initiative spending)</td>
<td>1.3</td>
<td>2.1</td>
<td>-8.9</td>
<td>0.3</td>
<td>-5.8</td>
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IMF and World Bank staff. 2003 data are estimates.

23. Efforts made during 1999-2000 to improve the tax audit units, raise the efficiency of operations and management at customs, and remove ad hoc customs exemptions did increase revenues but were not sufficient by themselves to reduce the budget deficit significantly. Electoral politics were an important factor in derailing fiscal discipline, compounded by the fact that expenditure management leaves room for the use of resources for non-programmed expenses. During 2001-2003 greater vigilance and better implementation (coordination among tax, customs and business registration) have led to higher tax revenues: from 16.1 percent of GDP in 1999 to 20.5 percent of GDP in 2003. Nonetheless, greater transparency and

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6Deficit data from IMF, excluding HIPC and interest obligations, grants and foreign-financed capital outlays. Percentage calculation based on IMF data estimates that the country's nominal GNP in 2002 is 53.6 billion dobras (August 2002).
management oversight of the budget framework and improved quality of public finance (including revenue collection and public expenditure) are still needed to counterbalance political influence.

3. Monetary and Interest Rate Policies

24. Monetary policy mirrored the fiscal developments. In 2001, net bank credit to the government rose by 17.3 percent, compared with the macroeconomic program target of 5.7 percent, and broad money expanded by 41.2 percent.7 The same pattern held for the first half of 2002, when broad money expanded by 30 percent in the first half of 2002. The government also drew heavily on its deposits at the central bank to finance the fiscal deficit.8 The driving force of these monetary slippages were the un-programmed expenditures for the presidential elections of July 2001 and the March 2002 legislative elections. By mid-2002 the government’s return to fiscal discipline was not fully reflected in the monetary sector. Thus, for the year, while net credit to the government shrunk by 0.2 percent, broad money expanded 41.3 percent. 2003 reflected an expansionary overall monetary policy, mirroring the fiscal policy of the government: M3 increased by 50 percent, leading to a monetary overhang that could lead to inflationary pressures. Credit to the government expanded also by 16 percent.

25. The financial market in São Tomé is very narrow and shallow: there is only one functioning bank, the International Bank de São Tomé and Príncipe (IBSTP).9 The role of the banking sector in financial intermediation thus is very limited, hampering financial and private sector development. Due to the lack of competition up to end of 2002, the spread between the average deposit rate (15 percent) and the average lending rate applied by IBSTP (37 percent) remains wide, leading to limited saving and lending activities. Rural credit is at an embryonic stage (Chapter 4). The real interest rate recently has been positive (8–12 percent in 1999, 3–5 percent in 2000 and 2001, approximately 6 percent in 2002 and 5 percent in 2003.

26. The government supports further development of the banking sector and licensed several private banks in 2003 and early 2004 to introduce competition to the supply side of the credit market. Overall, the small size of the market is a deterrent. Nonetheless, these new bank entries led the IBSTP to decrease lending rates to the private sector and adopt an aggressive lending policy to secure its dominant position in the market. Consequently, credit to the private sector grew from 11.6 percent in 2002 to 26.3 percent in 2003.

27. The Central Bank needs to strengthen supervisory and regulatory capacity to ensure the financial health of the sector and avoid money laundering. It is considering launching treasury bills that would provide it with another policy lever of control over liquidity in the economy. While a useful tool, treasury bills may not be at this time a good solution given the country’s

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7 In 2000, this increase had been 25.1 percent. (IMF April 2002 Briefing Memorandum and August 2002 data.)
8 IMF, October 2002.
9 The liquidation process of a second bank, the Banco Comercial do Equador (BCE) was launched in April 2002. In December 2002 the court declared BCE bankrupt and directed the Central Bank to facilitate the settling of depositors’ claims and finalize the closure proceedings. The liquidation process should be done without the treasury assuming any part in the restructuring or liquidation process.
lack of financial intermediation, the unavailability of credit for micro, small, and medium-sized businesses, the high lending rates, and low savings.

4. Consumption, Savings, and Investment

28. As is typical for small island economies, the country’s savings rates are low, reflecting a high propensity to consume. The government still dominates the economy through its consumption and investment decisions. It increased its consumption by an annual 8.6 percent in the decade to 2001 while private consumption as a percentage of GDP shrank by 6.6 percent annually in the same period, a consequence of the economic crisis that deepened poverty in the country. The government’s consumption reached 116.5 percent of GDP in 1997 and averaged 106 percent during the adjustment period of 1998–2000. Over 2001-2003, government consumption decreased from 123 percent of GDP to 108 percent of GDP despite contradictory pulls on the budget execution (Table A1.2). On the one hand, the 2001-2002 elections and the 2003 Coup led to increased expenditures. On the other hand, the government worked toward more fiscal discipline from mid-2002 through end of 2003.

29. Gross domestic saving has been negative over 1999-2003. It improved in 2000 due to the recent reforms and demand management policies, and deteriorated again due to the 2001 and early 2002 lax fiscal discipline related to presidential and legislative elections. The negative gross public savings, which peaked at 28 percent in 2001, drove the overall results while the gross private savings remained positive, though modest throughout the period. Private domestic saving increased from 2.3 percent of GDP in 1998 to 8 percent in 2000. It slipped back to 2.8 percent in 2002 due to lax budgetary discipline early in the year but rebounded to 6.8 percent in 2003 (Table 2.3).

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<thead>
<tr>
<th>Table 2.2: Domestic Savings and Investment (percentage of GDP)</th>
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<tr>
<td>Gross domestic savings</td>
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<td>Gross private savings</td>
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<td>Gross domestic investment</td>
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30. The savings–investment gap is largely funded through aid and external borrowing. Up to 2000, external funding constituted more than 95 percent of gross domestic investment (Table 2.3; also Annex I). This dependence has slipped noticeably to 83.4 percent in 2001, and 63.4 percent in 2003 due to two factors. The delivery of promised funds by the donor often has experienced delays affecting implementation of investment projects. Meantime, social pressures led the government to undertake investment projects to alleviate tensions, financing an increasing share of the investment budget from internal resources.

31. A number of major bilateral donors (France; Portugal; Taiwan Province of China; Japan) and multilateral organizations (UNDP, IFAD, IMF, European Union, AfDB, and World Bank) finance programs or projects in São Tomé and Príncipe. The lack of sustained and comprehensive government or donor-led coordination has fed into the “island development”
status quo, tends to have limited direct impact and is developmentally non-sustainable. The lack of adequate donor coordination is partially responsible for the low execution rates of the PIP. The insufficient coordination of activities and the poor matching of donor-earmarked funds with the country’s development priorities have compounded the low domestic absorption capacity, leading to a chronically poor implementation record. In 2001, a mere 50 percent of planned expenditure as actually executed. In 2002, the PIP execution reached 61.7 percent as a result of government efforts in improving coordination with donors and better supervision of projects implementation.

32. During 1999-2003, gross domestic investment constituted 30 percent to 40 percent of GDP and supported real GDP growth of 2.5 to 4.5 percent. The implied high Incremental Capital Output Ratio (ICOR)--more than 10 for 2001--matches that of similar small states (for example, the Marshall Islands, Tonga, Vanuatu, Samoa) and highlights several realities. First, the low productivity of public investment is partly explained by the natural constraints imposed by the small size and remoteness of the country, raising the unit cost of economic activities. Second, there may be inefficiency of the investment efforts attributable to an environment lacking the legal, institutional, and infrastructure framework to support economic growth, especially for the private sector. Third, the high ICOR also raises concerns as to the ability of the country to pay back debt, as the externally financed investment fails to produce the desired growth and income.

Table 2.3: Public Investment Program PIP (executions)

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<tr>
<td>External resource</td>
<td>21.8</td>
<td>19.8</td>
<td>18.3</td>
<td>17.0</td>
<td>14.1</td>
<td>17.5</td>
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<tr>
<td>Internal resource</td>
<td>1.3</td>
<td>1.01</td>
<td>0.43</td>
<td>3.4</td>
<td>4.0</td>
<td>9.8</td>
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<tr>
<td>Of which HIPC funds</td>
<td></td>
<td></td>
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<tr>
<td>Public investment project (as % of total)</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>External resource</td>
<td>94.4</td>
<td>95.1</td>
<td>97.7</td>
<td>83.3</td>
<td>77.9</td>
<td>63.4</td>
</tr>
<tr>
<td>Internal resource</td>
<td>6.0</td>
<td>5.1</td>
<td>2.4</td>
<td>16.7</td>
<td>22.1</td>
<td>36.6</td>
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<tr>
<td>Of which HIPC funds</td>
<td></td>
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<tr>
<td>Sources: World Bank and São Tomé and Príncipe authorities.</td>
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C. External Sector

1. External Vulnerability and Aid Dependence

33. As a small island state, São Tomé and Príncipe tends to experience a greater degree of volatility of per capita GDP growth than do larger countries. It registered a composite vulnerability index (CVI)\(^{10}\) of 7.69, ranking 17th highest in a sample of 111 small and large

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\(^{10}\) The composite index vulnerability of a country is the part of the output volatility explained by susceptibility to natural disasters, export dependence, and UNCTAD’s merchandise export diversification index.
states. This vulnerability is partly rooted in the country's longstanding dependence on cocoa which accounted for over 85 percent of all goods exports in 2003—because of the high world price volatility and changing demand for the crop. This dependence on cocoa exposes the economy to terms-of-trade fluctuation, chronic current account deficits, budgetary crises, macroeconomic misalignments, and increasing poverty when prices fall. The problem is compounded by the fact that São Tomé and Príncipe is a remote, relatively isolated economy, poorly served by expensive and infrequent air and sea services, and facing diseconomies of service provision and production in both the public and private sectors. In this sense, São Tomé and Príncipe shares some of the characteristics of other island economies, such as Palau and Samoa.\footnote{\textsuperscript{11}}

34. Due to this vulnerability and monoculture, the economy has been sustained by external resources (borrowing and aid). The country has been one of the major recipients of aid per head in the world: during 1985-89, average per capita net disbursement of official development assistance was US$208; in 1990-99, this average reached US$447.\footnote{\textsuperscript{12}}

\begin{table}[h]
\centering
\caption{External Aid and FDI (US\$ millions)}
\begin{tabular}{|l|c|c|c|c|c|c|c|}
\hline
\hline
Official transfers, net & 22.7 & 31.3 & 15 & 14.9 & 18.0 & 14.4 & 14.4 \\
Project support & 8.9 & 12 & 9.3 & 12 & 13.8 & 12.1 & 10.7 \\
Budgetary aid & 13.8 & 19.3 & 5.7 & 2.9 & 1.7 & 0.0 & 0.3 \\
Foreign Direct Investment & 1.9 & 0.4 & 3.0 & 3.8 & 3.3 & 5.2 & 8.0 \\
\hline
\end{tabular}
\end{table}

Source: IMF 2003 are estimates.

35. The country's heavy aid dependence has had both positive and negative impacts on the economy. External financing has permitted levels of imports, expenditures, and investment that otherwise would not have been possible to sustain. However, as can be seen in Table 2.4, while external aid is a consistent part of the São Tomé and Príncipe economy, its volume can vary greatly from year to year (from a high of US$31.3 million in 1997 to a low of US$14.4 million in 2003). The negative side of this is that the amounts, disbursement methods, and timing are determined by donor internal policies. This lends an element of unpredictability to the budgetary and planning processes, making the effective use of funds difficult.

2. **External Sector Development**

(a) **Balance of Payments**

36. São Tomé and Príncipe depends on cocoa exports for more than 85 percent of total goods exports. Cocoa export earnings have been affected by a downward trend and the price volatility associated with the cocoa markets. The downward trend reflects the loss in production and productivity over the 1990s of the cocoa trees, which are generally old, poorly tended, and were infected with Thrips insects. As a consequence, production and export volumes have stagnated.


\textsuperscript{12} The Economist Intelligence Unit, Country Profile 2001.
over the recent past. Export earnings have been affected by cocoa price volatility, dropping from US$5.0 million in 1994 to US$2.9 million in 2000, before rising to US$5.5 million in 2003. This accounts to a large extent for significant fluctuations in overall export earnings. As an illustration, earnings decreased by 17.9 percent between 1999–2000, then rebounded by 15.6 percent in 2001, and rose further by 37.8 percent in 2002 and by 25 percent in 2003. The moderated price increase in 2003 (6.8 percent) was accompanied by a supply response of the farmers to higher international prices (Table A1.2).13

37. The deficit in goods and services accounts led to chronic current account deficits (excluding official transfers) in the 1990s and up to 2003. The current account deficit (excluding official capital transfers) narrowed from 74.8 percent of GDP in 1997 to 51.1 percent in 1999 and 52.4 percent in 2000, as a result of reforms and general improvements in budget management. However, weak budgetary discipline in 2001 led to a deterioration to -63.0 percent of GDP for the year. With the return to budgetary discipline in 2002, the current account deficit fell to 49.0 percent of GDP and 41.8 percent of GDP in 2003. Due to debt relief, however, the overall balance of payment switched to a modest surplus of US$0.5 million in 2001. It turned into deficit in 2002 (US$-2.8 million) due to weaker-than-envisioned capital inflows and non-project grants and higher interest payments due. In 2003, the overall balance reached US$4.0 million resulting from the receipt of US$5.8 million of capital inflows compared to US$1 million capital inflows in 2002.

(b) External Debt and Enhanced HIPC Program

38. In addition to being a major recipient of aid, São Tomé and Príncipe borrowed abroad extensively in the 1990s. This debt, combined with poor economic performance, rapidly grew to US$294 million, or 624 percent, of GDP by end-1999. Fifty-seven percent of the debt was owed to multilateral creditors. The amount owed to the International Development Association (IDA) reached 20.7 percent of the total debt, the African Development Bank (AfDB) held 30 percent, and 43 percent of the debt was due to bilateral creditors, half of which is due to the Paris Club members. The high external debt level translated into indebtedness in excess of US$2,000 per person, resulting in frequent difficulties in staying current on debt service obligations.

39. São Tomé and Principe qualified for the HIPC initiative and reached the HIPC decision point in early 2001.14 Multilateral creditors and the Paris Club agreed to a total debt relief package amounting to US$97 million in end-1999 Net Present Value terms. This agreement provided the country with an 83 percent reduction in NPV terms of its outstanding debt at end-1999 (Annex II, Figure II.1). The debt service profile (Table 2.5) points to the sizable impact of the HIPC initiative on the annual debt service requirements, freeing up resources to be used to reduce poverty and to achieve the country's long-term development goals (Annex II, Table II.1).

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13 The world cocoa prices increased by 66 percent between 2001 and 2002, leading to terms-of-trade improvement of some 55 percent.
14 The Paris Club granted the country a rescheduling on Naples terms (67 percent reduction in NPV terms of eligible debt) in May 2000.
The committed HIPC interim assistance for São Tomé and Príncipe is estimated at US$2.3 million in 2001, US$2.3 million in 2002, and US$3.4 million in 2003.\(^{15}\)

**Table 2.5: Debt Service Profile**

(percentage of exports of goods and services, unless otherwise indicated)

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt service due</td>
<td>9.1</td>
<td>7.8</td>
<td>6.3</td>
<td>8.1</td>
</tr>
<tr>
<td>(US$ millions)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt service/exports before debt relief</td>
<td>83.1</td>
<td>49.8</td>
<td>36.2</td>
<td>31.4</td>
</tr>
<tr>
<td>Debt service/exports after debt relief</td>
<td>–</td>
<td>45.5</td>
<td>26.1</td>
<td>10.8</td>
</tr>
</tbody>
</table>


40. The financial requirements for 2001 were covered by concessional assistance from multilateral and bilateral donors, in line with HIPC initiative. However, progress toward HIPC completion point triggers stalled in November 2001 along with the IMF’s PRGF program, due to a number of policy slippages, structural reform delays, and governance issues.

41. In late 2002, the government resumed its efforts toward meeting the floating triggers and toward the completion point. An important criterion is the establishment of a good track record on stabilization under the IMF program. A number of the other trigger points have been achieved: the PRSP was finalized in December 2002 and the government is pursuing its implementation, albeit slowly. Governance/public expenditure management measures have been implemented: a National Petroleum Committee and a National Petroleum Agency were created in early 2004 to develop policy and oversee the sub-sector. The office of auditor general has been created and is operational. The government also is working toward achieving the social sector triggers, with assistance from the World Bank and other donors. In health, the 85 percent immunization rate for children (measles, diphtheria, tetanus, pertussis, and polio) has been achieved and often surpassed, and the building of eight health care centers is in progress.

42. Further delays in moving toward the HIPC completion point, especially in the macroeconomic arena, could jeopardize the interim debt relief the country currently receives and by extension the financing of ongoing poverty reduction and infrastructure projects. Suspension of the HIPC interim assistance would deprive the country of external resources deepen the deficit of the current account, and derail the country’s external economic standing, especially as regards further debt negotiations with bilateral and multilateral lenders.

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\(^{15}\) IMF estimates, October 2004  
\(^{16}\) The HIPC program started in June 2001. Data from the Treasury of São Tomé and Príncipe.
D. Sectoral Developments

1. Private Sector Development

43. The traditional dominance of the public sector since independence has resulted in the underdevelopment of the private sector. The private sector is dominated by a large informal sector of mainly small enterprises and micro-enterprises. The formal sector is composed of a few small and medium-sized enterprises. These latter are concentrated in the cities of São Tomé and Neves and account for more than 70 percent of non-agricultural employment. The linkages between enterprises are limited, as most enterprises sell their products directly to individuals rather than to businesses. Micro-enterprises tend to be labor-intensive, with very little investment in machinery or equipment. The range of activities is broad in both the urban and rural areas. There are no major international investors, although these may appear once petroleum-related activities start. At this stage the opportunities for diversification remain very limited and are mostly concentrated in the agricultural sector.

44. Key constraints, such as poorly functioning regulatory and judiciary frameworks, an inadequate fiscal framework and financial services, rigid labor markets, poor infrastructure, and high transportation costs represent a cross-cutting source of economic inefficiency for all private sector activities. These are accentuated by the small size and remoteness of the country and its limited natural resources, leading to a high dependence on imports.

Box 2.3: Private Sector Development: Recent Past and Reforms

São Tomé and Príncipe's business environment was for a long time shaped by the socialist tradition that characterized the post-independence period. As a result of nationalization, more than 80 percent of cultivated land was brought into state ownership; and until the mid-1980s the government owned almost all economic enterprises.

With the implementation of structural reforms since the late 1980s and during the 1990s, São Tomé and Príncipe has initiated a process of laying the groundwork for private sector development, in the expectation that this would serve as an engine for growth. The following reforms are noteworthy: (i) the contracting out of the agricultural public estates management to private operators under long-term leases; (ii) the creation in 1993 and 1995 of two private banks; (iii) the liberalization of prices; and (iv) the introduction in 1994 of a floating exchange rate.

2. Sectoral Developments

(a) Rural

45. The long post-independence economic decline of São Tomé and Príncipe was largely the result of the socialist policies that led to the slow decline of the cocoa-based plantation agriculture, the country's major productive sector. This trend continued in the 1990s, with the

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17 A brewery and hydrocarbons storage facilities are located in Neves.
18 In urban areas there are restaurants and bars, clothesmakers and shoemakers, carpenters and cabinetmakers, welders fabricating stoves, butchers, and so on. In rural villages, off-farm activities consist of farming cooperatives, fish processing, handicrafts, goat raising, food processing, wood carving, bamboo working, and other cottage production industries.
agriculture’s contribution to GDP falling from 28.9 percent in 1993 to 19 percent in 2003, mostly due to a decline in yields and a sharp fall in cocoa prices and export earnings (17.9 percent) in 1999–2000. The growth rate fell a further 2.8 percent from 1994 to 2000. Despite its general decline, agriculture—and more specifically cocoa—still constitutes more than 85 percent of the country’s goods exports and provides income for the rural population (46 percent of the population).

| Table 2.6: Structure of the São Tomé and Príncipe Economy |
|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| GDP             | 1993 | 2000 | 2001 | 2002 | 2003* |
| Agriculture     | 28.9 | 20.5 | 20.0 | 20.0 | 19.0 |
| Industry        | 19.7 | 17.0 | 17.0 | 17.0 | 18.0 |
| Manufacturing   | 6.5  | 4.5  | 4.1  | 4.1  | 3.9  |
| Services        | 51.4 | 62.5 | 63.0 | 63.0 | 63.0 |

* 2003 data are preliminary estimates.

46. The decline of cocoa-based plantation (roças) agriculture is mainly due to the high cost of labor that affected their profitability. The flight of technical skills, mismanagement and bad economic policies also contributed to the economic deterioration and the structural crisis of the sub-sector. Production levels dropped steadily from a high of 11,700 tons in 1973. Export volumes have been generally low and stagnating: from 3,716 MTs in 1994 to a low of 2,840 MTs in 1997 and 3,500 MTs in 2003. Market conditions have affected production and investment incentives: cocoa prices have experienced a long downswing since the 1979 collapse of the world cocoa boom, and cocoa also has displayed typical commodity price volatility, especially during 1999–2003 (Table 2.7). This volatility has affected the terms of trade as well as fiscal stability. Additionally, productivity has been low due to a number of factors, including the Thrips infection and consequent poor product quality; the aging of the country’s cocoa plants; loss of soil fertility due to lack of maintenance and use of fertilizers; the shallow pool of skills; and lack of extension support and market information. The current yield of dried beans for cocoa re-plantations in two large estates reached only 700 kg/ha on the best plots and only 350 kg/ha on average compared to the forecast of 1,500 kg/ha.

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19 The average yield of cocoa production decreased from 199 kg per hectare in 1988 to 98 kg per hectare in 1994 (IMF, São Tomé statistical appendix, May 1995).
20 Background chapter on agriculture and rural development for the CEM, 2002.
22 See Table A1 2 on key economic indicators; also IMF Article IV report, March 2004.
23 A mid-1990s recovery was reversed in 1998–99 by a 45 percent price drop, leading to a 50 percent deterioration of the country’s terms of trade. The years 2000–2001 was characterized by a shallow recovery that was tempered by the worldwide economic recession in 2001, translating into moderate gains in the terms of trade (some 11 percent). 2002 witnessed a 69 percent price upswing, leading to a 54 percent terms-of-trade improvement. The much smaller 2003 price increase (approximately 6.8 percent), only led to a slight terms-of-trade improvement.
24 The departure at Independence of many Europeans, along with many São Toméan elite and Cape Verdean laborers, contributed to this problem.
Table 2.7: São Tomé and Principe Cocoa Prices and Terms of Trade

<table>
<thead>
<tr>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cocoa*</td>
<td>126.7</td>
<td>168.4</td>
<td>114.3</td>
<td>93.1</td>
<td>106.9</td>
<td>166.8</td>
<td>179.4</td>
</tr>
<tr>
<td>Export GNFS Prices, base 1987</td>
<td>--</td>
<td>38.92</td>
<td>20.90</td>
<td>22.07</td>
<td>24.38</td>
<td>27.50</td>
<td>29.15</td>
</tr>
<tr>
<td>Import GNFS Prices, base 1987</td>
<td>--</td>
<td>32.85</td>
<td>35.30</td>
<td>37.69</td>
<td>37.60</td>
<td>41.36</td>
<td>43.01</td>
</tr>
<tr>
<td>Term of trade</td>
<td>--</td>
<td>118.45</td>
<td>59.19</td>
<td>58.54</td>
<td>64.83</td>
<td>98.99</td>
<td>100.89</td>
</tr>
</tbody>
</table>

Cocoa prices in constant 1990 US dollars (annual average cents/kg). IMF and WB staff calculations.

47. Land reforms in the 1990s of the plantations favored smallholders, who by 2000 held about 64 percent of these lands (Box 2.4). Some of these smallholders have switched from cocoa to the production of alternative food crops. Despite persistent low productivity, low use of agricultural inputs, and a small starting base for food production, they contributed to growth rates of 25 percent, 12.7 percent, and 23 percent respectively for banana, breadfruit, and taro over 1994-2000. In the process they have enhanced their incomes and food security in the rural and urban areas, and have contributed to product diversification.25 There additionally have been some attempts to grow fruits and vegetables, cut flowers, and spices and to produce essential oils; diversification nonetheless remains very limited.26 While this land reform has been an important factor in poverty reduction, not all of the rural population has benefited. Some smallholders, inexperienced in running their own farms and facing insufficient rural extension services, poor infrastructure, and with no access to credit, have cleared shade trees for fuel wood and other cash needs, and have reportedly abandoned large tracts of the cocoa plantations (to what extent is not documented), migrating to the cities in search of jobs.27 The depletion of the

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25 The economic argument is that, as cocoa production did not pay enough, farmers switched to products that were in demand domestically. This phenomenon was not universal, as other staples such as maize and palm oil have not followed this upward trend.

26 Avocado, mango, oranges, lemon, tomatoes, pepper, and cabbage are examples of such a diversification effort.

27 The National Support Program for the Promotion of Farm-Household Agriculture (PNAPAF) that was to provide farmers extension, basic rural infrastructure, and agricultural credit to accompany the land reform program did not alleviate these constraints. PNAPAF started in 1995, two years after initiation of the land distribution, and has postponed implementation of its agricultural credit component because the conditions were not right.
shade trees led to an outbreak of the Thrips infestation and to a decrease of productivity. Poverty may even have deepened in some sub-groups of the rural population who had no access to land and lost the non-monetary benefits and services they received under the “roças” system.

48. Other sub-sectors have fared better. The fisheries sub-sector contribution to GDP grew by 5 percent in 1994-2000, while that of the overall primary sector declined by the same amount. Between 2000-2003, the fishery share in the primary sector stabilized at 18 percent.\(^{28}\) Offshore fishing is undertaken primarily in accordance with a January 2002 convention with the European Union. A new agreement on tuna fishing came into effect on June 1, 2002 with a total compensation in the amount of US$1.9 million, 40 percent of which will be used for projects to support local fisheries, scientific research, and fishing surveillance.

49. Small-scale artisanal fishing constitutes about 90 percent of annual production. Angolares fishermen and the women (*palayès*) who dominate the fish trade have little if any other income alternative. Fish provides about 70-80 percent of the population’s protein consumption. Of other sub-sectors, livestock (primarily goats, sheep, pigs, cattle, poultry, and rabbits) provides both a source of income and food security for the rural population. The islands can support only a limited number of cattle (an estimated 380 head); however, livestock’s recent performance has been mixed with the number of small ruminants having fallen 42 percent since 1997. The number of poultry, in contrast, grew 9 percent in the same period.

(b) Industry

50. Industry (mining, manufacturing, construction, electricity, water, and gas) is handicapped by the size of the market and the historical dominance of the public sector, and overall has not shown noticeable growth in the past decade, contributing 16.7 percent of GDP (Table 2.6). Individually, construction has exhibited a more dynamic growth, contributing 8.6 percent of GDP in 1988 and 10.7 percent in 2003, but this sub-sector is highly dependent on foreign-financed construction projects. The embryonic manufacturing sector is composed of a few public and energy enterprises and a brewery, contributing 3.9 percent to GDP in 2003, down from 6.5 percent in 1993. The low share of manufacturing in GDP is similar to that of some of the Pacific Islands.

(c) Services

51. As is typical of many island economies, the role of the tertiary sector and particularly public administration is dominant. Services (tourism, trade, transport, government, financial and banking, professional and personal services, and real estate services) contributed 63.0 percent of GDP in 2003, up from 51.5 percent a decade earlier due to increased government consumption and a burgeoning tourism and transport sub-sectors. By way of comparison, the tertiary sector contributes between 55 percent and 60 percent of GDP in Fiji, Samoa, and Tonga. In 2003 the São Tomé and Príncipe public administration constituted approximately 40 percent of the sectoral activities. Commerce/tourism, financial institutions and other services represented 40 percent and 20 percent respectively.

\(^{28}\) IMF Article IV, March 2004, statistical appendix, table 1.
52. The country’s main services exports are air transport and tourism. Tourism and travel contributed US$9.2 million to the balance of payments in 1999 and US$11.6 million in 2003. The growth in this area is due mainly to the increase in petroleum-related business travel.\(^{29}\) Air travel services comprised a small but growing number of companies responding to demand for more frequent, competitively priced flights to a growing number of destinations.\(^{30}\) Cargo transportation earns the country some US$2 million per year in airport and port taxes, as well as engendering revenue through creating collateral business and other employment opportunities. The coming oil era is expected to boost both freight and passenger traffic.

53. Tourism is underdeveloped. The tourism industry is composed of a few companies providing tourism services such as boating, hiking, car rentals, and car tours. While acting in the formal economy, none of these outfits are properly monitored or regulated. Overall hotel room occupation rates are too low for profitability: 30.6 percent in 1999 and 41 percent in 2000.\(^{31}\) The problems hindering growth of the sector include a lack of marketing, the country’s geographic isolation, expensive and infrequent flights, low capacity, and health issues—especially the prevalence of malaria. The poverty reduction strategy paper (PRSP) identifies tourism as one of its main axes for growth and poverty reduction, and the Government has started implementing a newly adopted tourism development strategy that identifies a mixed approach. This approach targets the high-end, adventure market as the market niche that would leverage the islands’ comparative advantage in the industry, and includes rural tourism as an element of this new strategy. The government is seeking private and public international support for further development of the sector’s infrastructure and the marketing of the country.

(d) Petroleum

54. Although substantiated information on the sector is scarce, offshore petroleum resources are expected to be significant. Production is to start in 2008-10. The first budgetary impact has been in the form of one-off bonus payments on petroleum-related contracts of US$3-5 million per year in 2000-02. Potentially large signature bonuses are expected in early 2005 (US$40-100 millions) on the joint economic zone between São Tomé and Príncipe and Nigeria, which contains the most promising of the country’s petroleum prospects. The government wishes to establish a fund to preserve fiscal and macroeconomic stability and to save for future generations. In the first half of 2004, the government has established a National Petroleum Committee to oversee policy development and adoption in the oil sector and a National Petroleum Agency to prepare a legal, economic, technical and regulatory framework for oil activities, addressing such issues as exploitation rights, production sharing, and transparent management of oil revenues. The Bank is assisting the institutional development of the sector with its technical and legal needs (Annex IV).

\(^{29}\) IMF estimates.

\(^{30}\) In 2002 the number of airlines servicing the country grew from three (TAP-Portugal, Air São Tomé and Air Gabon) to four with the addition of Air Luxor, which provides seven incoming flights per week.

\(^{31}\) There is a total of 249 rooms. 145 rooms are in four-star hotels, 49 in three-star hotels, and 55 in other establishments. Two of the four-star establishments are geared toward tourism; the other two cater for a mix of tourists and business travelers. ECOFAC additionally offers an ecotourist alternative to the hotel stay: as part of its environmental protection work on the islands, it has developed a campsite to observe endangered turtles.
E. Social Developments

1. Poverty

The recent economic growth is starting to translate into higher income per capita for the population. Poverty increased between 1997 and 2000, with per capita income falling from US$300 to US$290 as a result of external shocks, the low level of domestic saving, lack of access to land and capital, and low overall productivity. By 2003, after 4 years of economic growth and low inflation, income per capita rose to US$320, suggesting a slight improvement in the income dimension of poverty.

Box 2.5: Poverty Profile, 2001

The 2001 household survey reports a rapid urbanization of the population, with 55.6 percent of households living in an urban environment (compared to 44 percent in 1992). There is also a concentration of the population in two major districts: Água Grande and Me-Zochi, which house 62 percent of households and 64 percent of the population. The average household size is 4.99, and 57 percent of the population live in a 4-7 member household. Approximately one-third of households covering one-third of the population, are led by women. The survey, which uses the average head of household expenditure as its criterion, identifies 53.8 percent of the population as poor (approximately below the US$310 line) and 15.1 percent as extremely poor (not reaching the US$155 floor). The poor spend some 79.1 percent of their income on food and the very poor, 81.7 percent. Overall, the poor spend more than 50 percent of their disposable income on basic food items such as banana, rice, miritaba, beans, vegetables, and bread, and find it difficult to afford meat, with the result that their diet is protein-deficient.

Poverty is more widespread, deeper, and more intense in rural areas. Sixty-five percent of the rural population lives below the poverty line and 22 percent below the extreme poverty line (compared to the urban rates of approximately 45 percent and 9.5 percent). Studies indicate that the families of plantation workers who have no access to land are the poorest, as average wages in the agriculture sector are the lowest in the formal economy. Furthermore, those families have lost many of the non-wage benefits offered by the roças. Along with lower incomes, the rural population also is disadvantaged through having poor access to markets and basic social services.

The residents of the northern region are most affected by the incidence (70.6 percent), depth (28.8 percent), and intensity (15.0 percent) of poverty (national averages are 53.8 percent, 19.2 percent, and 9.3 percent respectively). The center, including the capital, is the least affected (46.5 percent, 15.3 percent, and 7.0 percent). The study also identified a clear gender and rural bias in poverty distribution: the average expenditure is higher if the head of household lives in the urban area and is a man. Almost one-third (32.8 percent) of households are led by women: the incidence of poverty and extreme poverty among such households is 55.7 percent and 15.6 percent, compared with 53 percent and 14.9 percent for households headed by men. The incidence of poverty increases with the size of the household, reaching 70.1 (71.8) percent of households with 8 (10 or more) persons.

Finally, many other São Toméans live just above the poverty line. Overall, a large majority of the population is highly vulnerable to natural or economic shocks.

A 2000 poverty profile identified 53.8 percent of the population as poor and 15.1 percent as extremely poor (Box 2.5). Poverty is above all a rural phenomenon, with 65 percent of the rural population living below the poverty line and 22 percent below the extreme poverty line.

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32 Data on poverty obtained from draft Poverty Profile on Democratic Republic of São Tomé and Príncipe, 2000, May 2001, ILO/UNDP/World Bank. The survey also discusses other non-income monetary criterion, such as education, health, illiteracy, and access to clean water.

33 Using the average head of household expenditure as criterion, the poverty line is 2,638,618 dobras (approximately US$310) and the extreme poverty line is 1,319,309 dobras (US$155) per year. This extreme poverty threshold is one-third of the average expenditure per head of household.
The incidence of poverty and extreme poverty is slightly higher in households led by women (approximately one-third of all households) than those led by men. Poverty in São Tomé and Príncipe also has a geographical dimension, with the residents of the northern regions more likely to be poor, and poverty being deeper and more intense. The center, including the capital, is the least affected. In general, the poor and very poor spend some 80 percent of their income on food.

57. The Gini coefficient for São Tomé and Príncipe is estimated at about 0.59 for 2000, indicating high inequality. Empirical work suggests that the more equal is the distribution of assets such as land, the higher growth rates tend to be. Furthermore, recent analysis shows that when the poor benefit from growth, the average income of the poorest fifth of the population rises proportionately with the average income.

<table>
<thead>
<tr>
<th>Table 2.8: Poverty Measures and their Elasticities with Respect to Mean Consumption and the Gini Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poverty Measures</td>
</tr>
<tr>
<td>Headcount index</td>
</tr>
<tr>
<td>Poverty gap (PG)</td>
</tr>
<tr>
<td>FGT2 index (severity)</td>
</tr>
</tbody>
</table>

58. Analysis of per capita expenditure obtained from the 2000 household survey suggests that changes in income (mean consumption) and the Gini index have a more pronounced impact on the poverty gap and the severity of poverty than on the headcount index (Table 2.8). The above analysis implies that rising incomes accompanied by improvements in equity would be the most effective policy to reduce poverty at the national level and supports the poverty reduction strategy of the country, which aims at reducing the numbers of the poor by promoting a wide-based, redistributive, private-sector-driven economic growth.

2. Social Sectors: Health and Education

59. The once superior infrastructure and results of the health and education sectors have been eroded by the economic crisis of the 1990s. Both the I-PRSP and the PRSP have identified these sectors as priority sectors, and the government has allocated an increasing amount of funding and attention to them since the adoption of the I-PRSP, backed by strong donor support. The share of health and education in GDP has increased substantially in the past few years (Table 2.9).

34 Ginic coefficients comparable to that of São Tomé and Principe are not uncommon. Nicaragua’s Gini was 0.60 in 1998 and Guinea Bissau’s was 0.56 in 1991. Swaziland and South Africa also had similar Ginis in 1994. (Comparator country data obtained from World Bank WDI site. STP Gini calculated from the 2000 Household survey data base by Bank Staff.)

35 D. Dollar and A. Kray, “Growth is Good for the Poor.” March 2001 draft.

36 This analysis finds a poverty line of 2,402,000 dobras and a headcount index of 61.3, a lower poverty line and higher index than the government’s official 53.8. This is mostly due to the fact that it does not adjust for rural-urban divisions or CPI. The poverty gap was 29.9 and depth 18.2.
60. The PRSP budget programming sustains social expenditure up to 2010. Each sector has elaborated a strategy that defines its goals and addresses its institutional and functional weaknesses, with the ultimate objective to provide quality universal services.

Table 2.9: Health and Education Expenditure (as percent of GDP)

<table>
<thead>
<tr>
<th>Year</th>
<th>Health</th>
<th>Education</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>5</td>
<td>2.2</td>
<td>7.2</td>
</tr>
<tr>
<td>2001</td>
<td>8.6</td>
<td>11.4</td>
<td>20.0</td>
</tr>
<tr>
<td>2002</td>
<td>2.7</td>
<td>9.0</td>
<td>11.7</td>
</tr>
<tr>
<td>2003*</td>
<td>5.8</td>
<td>10.5</td>
<td>16.3</td>
</tr>
</tbody>
</table>

Source: IMF data. * indicates estimates.

(a) Health Outcomes

61. Malaria affects some 80 percent of the population. It is the leading cause of morbidity and mortality for all age groups, and is the cause of one-half of all deaths among children under five. In general, 60 percent of all hospital beds are occupied by malaria patients. The prevalence of malaria seriously reduces the prospects for development, particularly in tourism and agriculture. National productivity is severely affected as each São Toméan succumbs two or three malarial episodes per year, each lasting on average 1 week to 10 days. Based on the conservative assumption that only one adult wage earner in the household is affected and that he or she does not tend to any other family member who may be ill with malaria, the disease deprives the household of approximately one month’s salary per year per adult wage earner—an estimated national average of Db$150,000 in 2000.

62. Generally, poor health affects mainly the poor and the rural populations. In 2000, 3.5 percent of the expenditures of the poor was on health. Inequalities in the provision and utilization of health services put the rural and poor communities at a further disadvantage (Chapter 3).

63. Life expectancy for men is 62 and for women, 65. The country has relatively high rates of maternal mortality (122 for 100,000 in 2000) and of infant mortality (71 per 1,000 live births in 2000). A high fertility rate (5.9 children per woman in 1991) is one of many impediments to female and child health. Transmissible preventable diseases are the main cause of morbidity and mortality. Acute respiratory infections and acute diarrhoea diseases are the second and third causes of poor health and disease in children after malaria. Sexually transmitted diseases present a growing trend (around 20 percent of pregnant women in consultation present some type of genital infection). HIV prevalence in the general population is currently 1 percent, providing a window of opportunity for AIDS prevention initiatives. Recent survey data suggest a deterioration in nutrition: malnutrition and other nutritional deficiencies of vitamin A, iron, and iodine are serious contributors to ill health among young children. Some estimations suggest that as much as 15 percent of deaths among children under five, in particular among the poor, are directly related to nutritional deficiencies.

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37 PRSP, December 2002.
There are some brighter areas in the health area. Immunization coverage is relatively high. There is a positive trend in reproductive health, and in particular maternal health: prenatal coverage rose from 66.5 percent to more than 84 percent between 1995 and 2001, and postnatal coverage almost doubled from 24.5 percent in 1997 to 41.6 percent in 2001. Finally, contraceptive use doubled between 1995 and 2001 to reach 22.5 percent.

An independent assessment of the potential for achieving the health Millennium Development Goals (MDGs) suggests that they are at least partially achievable in São Tomé and Príncipe:

- The first MDG is to reduce child mortality by two-thirds by 2015, signifying the achievement of a drop in infant mortality from 58 per 1,000 live births (ptlb) in 2000 to 23 ptlb in 2015; to achieve a drop in mortality among children under five from 75 ptlb to 30 ptlb, and to increase measles vaccination coverage from 69 percent to 100 percent in the same period. Based on the progress achieved toward the first two indicators over the past decade (a decline in mortality of only 16.9 percent), the MDG goals may be out of reach. The vaccination rate, however, is already high and full coverage is achievable by 2015.

- The second MDG goal is to improve maternal health: to reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio (MMR), as measured by the MMR and the proportion of births attended by health personnel. Data on the MMR are scarce and unreliable; however, the proportion of births attended by health personnel is on the rise, and if the supply of service continues to improve, the MDG is achievable.

- The final health MDG goal is to halt by 2015 and to begin reversing the spread of HIV/AIDS. The incidence in São Tomé and Príncipe of AIDS is still low, presenting the country with a window of opportunity to prevent its spread. Although the fight against AIDS is a priority of the new government, it still has to be translated into practice by providing resources and ensuring the involvement of all other sectors. Implementation of the National AIDS Strategic Plan should be pursued as a matter of national urgency.

(b) Education Outcomes

The most important problem facing education is that its structural inefficiencies mean that children are not being educated effectively, sufficiently, or in marketable skills. The sector’s overall performance suffered during the 1990s as it was strongly affected by economic difficulties. Adult literacy rates collapsed to 63 percent in 1999, compared to 73.2 percent in 1991, and there is still a marked gender imbalance in literacy among the adult population.

Net school enrolments declined from a peak of 96.3 percent in 1990 to 77.6 percent in 1999, a decrease of nearly 19 percent in 10 years. These retreats took place at a time when the rest of Sub-Saharan Africa was registering advances (Chapter 4). In 2000-01 the number of

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38 Immunization coverage in 2000 was 81 percent for BCG (anti-tuberculosis vaccine), 82 percent for DPT3 (the third dose of the diphtheria, pertussis, and tetanus vaccine); 86.3 percent for polio3; and 67 percent for measles.
students in primary education was 23,760, and the student to teacher ratio was around 35.39
Almost half the 673 teachers at this level have no specific or professional training. The number
of students in the secondary system was 2,537.

68. The lack of funds, classrooms, and trained teachers, together with increasing demand, has
affected all levels of education, producing overcrowded classrooms and two-or-three-shift
classrooms. The effective learning time in double-shift classrooms is about four hours, and in
triple-shift classrooms only about two hours, affecting the learning and skills acquisition of the
students. Learning is further hampered by high school teacher and student absenteeism as a
result of malaria.

69. These conditions have created serious accessibility and equity issues, with the rural poor
most badly affected. Primary education is four years instead of the international norm of six
years, and the number of lower secondary schools (years five to seven) is limited. Secondary
education only runs to grade 11, and access to a full course of education is again limited.40 Only a
few students reach the top of the educational system and the poorest are usually among those
excluded. A further consequence of this unbalanced repartition of the schools is the pressure on
the main high school, the Liceu Nacional, where two-to-three-shift classes are common and
classes may have as many as 70 students.

70. Tertiary education is limited mainly to scholarships abroad, and these are rare since the
collapse of the socialist systems. Two training institutions are available: The Centro Politécnico
provides professional and technical training. Between 1987 and 1995, it trained around 300
technicians in the areas of building and civil construction, electricity, and mechanics. The
Instituto Superior Politécnico (ISP), created in 1998, mainly provides training for teaching staff
for secondary schools.41 Unless they go to one of these training schools, most high school
graduates have no opportunity for further education. Those skills that they are taught,
furthermore, seldom match the needs of the labor market, so that many end up joining the ranks
of the unemployed.

39 2000-01 data from Ministry of Education tables, May 2002. Primary education students totaled 21,016 and the
number of teachers was 638 in 1995-96 and 673 in 2000-01.
40 Secondary education is presumed to be Y7-Y11, and pre-university Y12. Y7 and Y8 are provided in eight
schools; Y9 in three schools; Y10 in two schools and Y11 in one school. Y12 has never been implemented.
41 Another private institution, Instituto Universitário de Contabilidade e Informática (IUCAI), also provides
university-level training in informatics and business management, in collaboration with a Portuguese university;
however, courses are currently suspended due to administrative difficulties.
71. The millennium development goal for universal primary education by 2015, also reflected in the PRSP goals related to literacy and net school enrolment rate, should be achievable in 2005 and beyond, given the country’s low population growth and the provision of sufficient institutional and financial support (Chapter 4, Table 4.5). However, while the PRSP suggests that gender equality should be sought, no specific indicator or milestone is included to capture the MDG goal of eliminating the slight gender disparity in primary and secondary education which should be preferably by 2005 and, in all levels of education, no later than 2015. The educational system will need to establish partnerships with civil society and communities to achieve this goal.

F. Lessons from Recent Experience

- Recent reforms have ensured a more stable macroeconomic environment, but the economy remains vulnerable and its recovery fragile. The reforms have broadened the role of price incentives in allocating resources more efficiently, leading to a more competitive, incentive-based economy. The ongoing slow paced-institutional and legal improvements also are gradually facilitating the process by which economic signals and incentives reach economic actors.

- The reforms are still being offset by a number of factors. The public sector, representing 67 percent of GDP in 2003, is still the dominant economic player. Delays in the implementation of key reforms and the government’s weak institutional and governance structure have obstructed the development of a market economy. Structural rigidities such as those of the labor market also are hindering economic activity.
G. Looking Ahead: Reforms and the Economy

One message is clear: given the fact that the country expected, by 2008-2010, to be engaged in oil production, and that the Poverty Reduction Strategy (PRSP) is centered on the development of the private sector as the engine of growth, the pace and focus of the reform process should be altered. With São Tomé and Príncipe’s weak institutional capacity, reforms should be prioritized. Chapter 4 discusses the priority actions that would engender private-sector-led growth and economic diversification. Chapter 4 discusses the aggregate priorities and challenges facing the economy. Improvements in health and education, the provision of basic institutional, legal, and regulatory frameworks, and improvements in public administration (budgetary and fiscal structures) should take front stage to prepare the country for a true modernization of the economy, integration into the global markets, and for the prospective petroleum wealth. Chapter 5 provides a brief analysis of the medium-term prospects of the economy.
3. PRIVATE SECTOR-LED GROWTH AND ECONOMIC DIVERSIFICATION

73. São Tomé and Príncipe’s poverty reduction strategy, finalized in December 2002, seeks to significantly reduce poverty by 2015. The overall medium- and long-term objectives include economic, social and institutional goals. The government wished to see GDP growth rate attain 5 percent starting in 2003 and has set ambitious poverty reduction goals: to reduce by half the percentage of the population of São Tomé living in poverty (53.8) by 2010, and to reduce this figure to less than one-third by 2015. Another goal for the country is to enjoy universal access to basic services by 2015, accompanied by improved quality of life which includes a reduction in the social and gender gap. Finally, the PRSP promotes institutional capacity-building and a policy of good governance.

74. To achieve these goals the PRSP accurately identifies five basic pillars: (i) to stimulate economic growth, especially through promoting private sector activities, tourism, and rural development; (ii) to create opportunities to increase and diversify income, especially for the poor; (iii) to reform public institutions, build capacity and promote good governance; (iv) to develop human resources and access to basic social services; and (v) to implement mechanisms for monitoring and updating the strategy.

75. The broad-based private sector development is a cornerstone of the PRSP’s strategy to accelerate and distribute growth and alleviate poverty. Given their experience with cocoa exports, the São Tomé and Principe authorities realize that a diversified economy tends to be more resilient to shocks when it does not rely on a single source of growth and income generation. The PRSP builds on this strategy to avoid reliance on petroleum revenues (expected to begin in 2008-10) and recognizes the need for expanded trade relations for the long-term economic development of the islands. A diversified private sector is expected to alleviate some of the predominantly rural poverty by providing sources of income for the rural poor. Diversification can instill a culture of productive efficiency and competition if it is supported by non-distortionary incentives, especially with the government’s scaling back its involvement in the economy (through divestiture, for instance) and adopting a more regulatory and promotional role.

76. Diversifying the economy will present a major challenge. The handicap of remoteness (distance, fixed costs of entering a new market, and informational barriers) clearly reduces the possibility for economic interaction. Recent work suggests that more than 70 percent of a country’s per capita income can be explained by the geography of access to markets and to sources of supply of intermediate inputs.\(^\text{42}\) Furthermore, simulations suggest that transportation costs can inflict a heavy economic loss on a country: a 10 percent ad valorem transport cost on both final and intermediate goods could reduce domestic value added by 30 percent.\(^\text{43}\)

\(^{43}\) Compared to a hypothetical country with no transport costs (S. Redding and A.J. Venables, 2000).
77. As São Tomé and Príncipe is far from Europe, its main market, it is on a low-intensity route and a small market destination, it may not benefit much from the global decline in sea freight costs and containerization. Establishing regional links thus could be beneficial for diversifying the economy and creating a future platform for integration into the world economy. Such a regional effort could be on an expanded bilateral basis with Cape Verde, Gabon, Angola, Nigeria or other countries, or as part of a regional economic association. The fixed costs of informational barriers and of breaking into a new market and matching its standards and consumer demands can be mitigated via the knowledge spillover effect of a regional platform. Given the country’s transport cost profile, for the more distant trade partners such as Portugal, the Netherlands, and France a more viable diversification effort might be the development of high-value products such as pepper, and tropical flowers, or fruits, all of which could be air-shipped. The viability of such a strategy would be contingent on improving the air transport schedule and lowering its transport costs.

A. Engendering Private Sector Growth

78. As discussed in Chapter 2, the private sector is weak, small, and mostly informal. The PRSP analysis identifies the factors to stimulate a diversified, private-sector-driven growth accurately: (i) deepening legal and administrative reforms; and limiting the active economic role of the government; (ii) reforming the fiscal environment (investment and tax codes) to facilitate business activities; (iii) mitigating infrastructural constraints such as transportation, utilities and communications; and (iv) stimulating domestic savings, credit and investment via financial sector reform. The key measures are discussed further and key priority policies and actions (short- and medium-term) are summarized in Annex V.

1. Reform of the Business, Legal, and Administrative Systems

79. Reform of the business, legal, and administrative systems is clearly necessary to encourage private sector development. Currently, no legal framework exists for bankruptcy, restructuring, mergers and acquisitions, arbitration, and intellectual property. Contract enforcement and dispute resolution are critically weak and debt recovery is very difficult. Weak property rights compound this limitation. To compound the legal shortcomings, the business regulatory environment is also unattractive, and private sector activities are constrained. The business authorization and licensing process is cumbersome and costly: for example, obtaining a licence requires 15-20 days, 8 documents, the involvement of several institutions, and costs some US$38. Importers and exporters have to be registered and pay nominal fees. Registration of corporations for São Toméan entrepreneurs is restricted by very high start-up capital.

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44 Hummels (1999; 2000)
45 Nicita and Olarreaga (2000); Nicita et al. (2001)
46 The list of necessary documents includes the following: request to the Director of Commerce and Industry; drawing of the installation and location; identity card; project analysis summary; land documentation; tax identification; and request for a fiscal administration visit. For shops, only the application, the identity card, and the drawing of the facilities and location are needed.
requirements (approximately US$1,200). The registry is still completely manual47 and a further complication is that the commercial registry is mixed in with the civil and land registry instead of functioning on a standalone basis. Finally, notary and civil registry laws need to be updated.

80. Reforms would include the Directorate of Commerce and Industry focusing on making policies rather than on collecting administrative fees. Licenses should be issued with a minimum of bureaucracy and delay, for a minimum flat fee, and for statistical purposes only. Import and export registration and fees should be removed; the establishment of a “one-stop shop” could be a natural extension of this reform process.

81. Adopting the OHADA regional business legal framework would have the dual benefits of allowing São Tomé and Príncipe to become part of a regional legal system that has also a defined set of institutions necessary for its implementation (Box 3.1) without requiring excessive resources for complete legal reform.

Box 3.1: OHADA: A Regional Business Legal Framework

The harmonization of business law in Africa, OHADA, is a regional business legal framework set up by a treaty signed in October 1993 in Port-Louis, Mauritius, which any member state of the Organization of African Unity may join. Its purpose is to ensure a secure legal environment through the harmonization of business law so as to promote regional integration and economic growth. The following texts, known as “The Uniform Acts,” have already been adopted by the Council of Ministers: (i) General commercial law, (ii) Corporate law and rules concerning different types of joint ventures, (iii) Laws concerning secured transactions (guarantees and collaterals), (iv) Debt recovery and enforcement law, (v) Bankruptcy law, (vi) Arbitration law, and (vii) Accounting law. The following regulations are also to be harmonized: labor law, sales law, ground transportation law, competition law, intellectual property law, banking law, and contract law.

The uniform OHADA law is applicable in 16 African countries: Benin, Bissau, Guinea, Burkina Faso, Cameroon, Central African Republic, Chad, Comoros, Congo, Côte d’Ivoire, Equatorial Guinea, Gabon, Guinea, Mali, Niger, Senegal, and Togo.

OHADA is based on four institutions: (i) the Council of Ministers of Justice and Finance, which is the legislative body; (ii) the Common Court of Justice and Arbitration, based in Abidjan, Côte d’Ivoire; (iii) the Permanent Secretariat, based in Yaoundé, Cameroon, which is the administrative body; and (iv) the Regional Training School of the Judiciary, based in Porto Novo, Benin. The school offers an initial and continuing education to judges and lawyers on OHADA law.

82. In the agricultural sector, priority is new land legislation to: remove uncertainty regarding land tenure rights and use (properly registered cadastres, usufruct titles, inheritance, rental), to extend arable land for agricultural, silvicultural, or pastoral uses, and to enable the use of local community control and land management which forms part of the public patrimony (forests, housing, and related areas). In the same vein, the government needs to simplify the land title registration process, register nationalized lands, and gain greater control of forest exploitation. Finally, one law should define local authorities for villages and dependencies, and another should define collectively owned structures.

47 Despite the fact that training had been provided under a previous IDA-financed project, the envisaged computerization of the commercial registry, the land cadastre, and the notary services have never materialized.
2. Reform of the Economic Role of the Government

83. Measures taken to limit the active economic role of the government should include its reduced intervention in the factor markets and the renewal of its political will to push ahead with restructuring and privatization efforts. The government is still a dominant presence as an economic actor and leading employer and land owner and the PRSP recognizes the necessity of its withdrawal from economic activities. The country’s slow and incomplete privatization process has inhibited private sector engagement in industry and agriculture. Most of the privatization program was carried out in the early 1990s as a means to end the public sector’s participation in direct economic activities, especially in the agricultural sector (Chapter 2). In October 1999 the Government adopted a new public enterprise reform and privatization program that covered 8 firms; since then, two companies have been liquidated. The remainder of the program has progressed slowly for many reasons, including lack of institutional capacity, mis-assessment of property values, slow negotiations with co-owners, lack of bids for the properties offered, and political and administrative deadlock during 2001 and 2002.

84. The government should review the privatization process, analyze its efficiency gains and poverty impact, reformulate the policy to better suit country conditions and needs, and reinvigorate the process with a new action plan and timetable. The government should also consider going further in its land reform process. Before doing so, however, it should finalize the legal framework of land ownership and take mitigating steps to avoid the negative impact on the environment and immigration that has characterized its land reform efforts to date.

85. While there are no restrictions on hiring and firing in the economy, the public sector, together with strong civil service unions, has contributed to the creation of labor market rigidities through centralized wage setting and public sector pay awards. The ongoing civil service and public sector reforms should consider alternative employment and wage setting formulae, such as performance bonuses, to introduce a more competitive, flexible, and efficiency-oriented labor structure in the public sector and, by extension, in the economy (Chapter 4).

3. The fiscal environment for private sector development is slowly becoming more business-friendly, but further reforms are needed in the tax and investment regime

86. Enhancing the competitiveness of the economy requires consistent and simple taxation of productive activities and a simplified administration. The government is undertaking economy-wide tax reforms that are expected to broaden the tax base, thus easing the tax burden on the few large contributors. The changes also are designed to formalize further the largely informal economy and to lay the fiscal and tax groundwork for a modern economy by shifting the generation of tax revenue from trade taxation to income and indirect taxation (Chapter 4).

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48 In 1998, the government partially privatized ENCO (energy company). Two firms have been privatized since 1999: the meat processing concern ENCAR and a medicine distribution company (ENAMED). Other firms under this privatization program include: EMAE (utilities), Pousada Boa Vista, Cunha Gomes, Air São Tomé, and EMOLVE.
87. Investment regulations need to be formalized and further revised. Investments still are governed by the October 1992 investment code, a complex and time-consuming procedure requiring substantial administrative resources. A new investment code was prepared in 2001 as part of the new tax code that is to be presented to the National Assembly; the new code, which defines the legal framework for investments of US$250,000 and above, provides a simplified and more accessible set of rules for investors. Fiscal incentives will be dealt with in the new national tax code to which both foreign and domestic investors will be subject. The application/approval process will be simplified under the new investment regulation: only four documents will be required for submission to the Ministry of Finance and Planning (MoFP). The 45-day approval delay, however, is long by international standards and should be reduced.49

49 After this 45-day delay, unless otherwise advised, the investor can assume his or her proposal has been approved.

88. Investors will benefit from non-discrimination in all phases of the investment process: from freedom of economic activity, including the transfer of funds out of the country; equality before the law; free competition; and protection of property rights. All investors will be prohibited from engaging in unfair competition. Further clarification of the expropriation clause of the law and the list of excluded sectors still needs to be made.50 Under the new investment code, the Government also will facilitate accelerated land concessions for construction and will propose government-owned buildings for investor use for the duration of their investment. This offer could possibly confer large gains to the investor and needs to be carefully analyzed in terms of its cost for the state budget and national wealth. If, following further cost-benefit analysis, the government decides to keep this incentive, clear project selection criteria should be drawn up and a transparent implementation procedure established to avoid governance issues.

4. Need for Better Access to Formal Sources of Credit

89. Small- and medium-sized enterprises and micro-enterprises are severely constrained by lack of access to formal sources of credit. For the SMEs, the most established and active bank, BISTP, still has the latitude to set unchallenged its lending rates and loan amounts. However, the entry of 2 more banks in 2003 has led BISTP to reduce its lending interest rates and increase aggressively its credit to the private sector. The country has no developed formal savings and credit associations and no urban micro-credit system. In rural areas, the embryonic rural micro-finance system that was started by the Caixas Rurais was near collapse in 2001 due to government actions taken during the election period, and is being revived slowly through the fledgling NGO Micondo.51

50 Two important weaknesses to the new code need revision. First, a great improvement would be to clarify in a list the economic sectors that are not open to investors, including defense, public order, central bank activities, investments financed by the state, investment in the Export Processing Zone (covered in other decrees). Second, the government guarantees the respect of private property but then includes expropriation of property at fair price as an option. The article needs to be brought up to international norms in terms of the legal and financial details of the expropriation.

51 The government distributed donor funds during an election year without clear criteria for eligibility, repayment, or collateral requests. This undermined the budding micro finance system developed by Caxas Rurais and it could not compete, eventually stopping its activities.
90. The government supports the establishment of additional private banks to encourage competition and to provide financing for SMEs. However, market size is still a major constraint. Also, the failure of the Banco Comercial de Equador (BCE) in 2001 and its lengthy bankruptcy procedure suggests that the Central Bank will need to implement a better supervisory and regulatory framework to avoid further governance issues in the banking sector.

91. The PRSP also highlights the need to develop and consolidate a micro-credit infrastructure along the lines of the Caixas Rurais. This would require the adoption and application of a legal status for the credit institutions, the definition of homogeneous financial rules across all these types of institutions, and the integration of the micro-credit chain into the national banking system through revision of the banking law. To ensure proper regulatory and financial oversight it would be necessary to train the management teams of these institutions.52 Government efforts would need to be coordinated closely with NGOs and the donor community who could provide the start-up funds for the system. This system should be based on the principle of mutual savings and credit associations. Its main characteristics should include positive real interest rates, extended credit for time periods commensurate with the object being financed, a requirement for auto financing and guarantees, and the use of credit for productive purposes. Any such system should cover the gamut of rural activities, and should include smallholdings, fishing, animal production, and agro-processing.

5. Removing Transport and Market Infrastructure Limitations

92. Transport and market infrastructure limitations reduce effective market size since they prevent exploitation of the gains from arbitrage. The overall impact of such limitations is to reduce the potential of existing businesses and to discourage new investors.

93. The state of road degradation makes it a prerequisite for any strategy aimed at reducing poverty through increased market production to improve the network. São Tomé and Príncipe has 131 kilometers of trunk roads, 67 kilometers of secondary roads, and 250 kilometers of passable rural roads. The majority of trunk and secondary roads are paved, and some major rehabilitation has been carried out in recent years.53 Most rural roads, however, have been badly neglected since the demise of the plantations and are in poor condition. There is no national road system maintenance program due to the weak capacity of the national road agency SENAE, which is inadequately staffed and under-equipped, and insufficiently funded. Virtually all financing for road construction and repairs comes from external sources.

94. Despite the obvious and severe problems with the roads, the condition of the main roads in general does not place an immediate constraint on tourism and private sector development; however, to support the medium- and long-term future of both sectors, these roads must be extended and improved. The poor condition of secondary and feeder (rural) roads in contrast is a major contributor to rural poverty, and effectively isolating the rural population is a constraint on

52 See also “Carta de politica agricola e de desenvolvimento rural,” Agosto 1999, Ministry of Economy, Government of São Tomé and Príncipe.
53 These were on the Ribeira Peixe to Porto Allêgre road, the Neves to Santa Catarina road, urban roads and drainage in the capital, and urban roads in Sto Antônio (Príncipe). The Neves to Santa Catarina road (US$8 million), urban roads and drainage in the capital (US$2 million) were financed by Taiwan.
agricultural development. Specifically, the situation puts serious constraints on: (i) the transport of agricultural products to the market and of essential goods to the home or farm; (ii) access of service providers; and (iii) access to schools and work places.

95. Experience in other countries shows that secondary and rural feeder roads are best maintained where responsibility for those roads is at the local level. Given the poverty in rural areas, the high susceptibility of the terrain to erosion, and no realistic expectation of cost recovery, this is not the best option for São Tomé and Príncipe. For the medium term and especially in the agricultural sector, the government should provide public infrastructure and utilities. ThePRS planned the construction or rehabilitation of 85 kilometers of rural roads in 2003, at a relatively high cost, to alleviate some of the constraints faced by rural communities.\textsuperscript{54} A further infrastructure program is to be developed for 2004 to 2006. The government may wish to consider the following as priorities for this next program: (i) the maintenance of existing roads to prevent their further deterioration; (ii) the rehabilitation and construction of rural roads; (iii) the reconstruction of trunk roads to isolated areas, especially southwest of the main island; and (iv) the upgrading of roads (widening, reconstruction of culverts and bridges, and installation of traffic safety features).

96. The low frequency and high prices of air service and poor airport infrastructure are significant barriers to the development of the agriculture and tourism sectors. Flights from Air Portugal, Air Gabon, and Air Luxor to São Tomé totaled 7 per week in 2003. Airfares to Europe, while high, are comparable to those of other airlines with similar-mileage destinations.\textsuperscript{55} There are, on average, three cargo flights per week and the demand is likely to grow substantially with the onset of the petroleum era. The airport reception and departure areas are not large enough nor properly subdivided and serviced to accommodate an increase in the number of passengers and goods. The aviation safety system (the telecommunications and navigation systems) needs to be modernized. The 2,200-meter runway is too short and is not reinforced for larger planes, limiting its use for stopovers to and from southern Africa (larger charter planes typically need a 3,000-meter reinforced runway). Although modernization would cost an estimated US$20 to 25 million, it would reduce import costs and enhance the competitiveness of the country.

97. An upgraded airport would enable the expansion of tourism, transportation services exports, and the export of fresh fruits and vegetables, flowers, and fish to Europe and regional markets.\textsuperscript{56} The government intends to implement an “open sky” policy, and should perhaps review the legal, technical, and infrastructural aspects of the aviation sector in support of its goals. It should move ahead quickly with redrawing the legal and regulatory framework, removing the air travel and handling monopoly held by TAP-Portugal/Air São Tomé, and

\textsuperscript{54} Building 85 km of paved roads would cost US$25.5–40.0 million. The construction of a 5.2-meter-wide paved road costs US$300,000 per km without drainage and US$470,000 with drainage. The cost structure is equivalent to the cost of 6.5-meter-wide road in other parts of Africa. The steep terrain and high rainfall call for the construction of numerous bridges and culverts and higher design standards for drainage; roads also require more frequent repairs.

\textsuperscript{55} São Tomé to Lisbon with TAP is approximately US$660, compared to France-Isle Maurice by Air France at US$740. ("São Tomé: Rapport Intermédiaire sur le Tourisme," 2001, World Tourism Organization.)

\textsuperscript{56} There is demand for stopovers of flights from Europe to southern African destinations (using larger planes), and for more air cargo capacity to serve oil platforms in the region.
Privatizing or contracting out the handling services and even the management of the airport to the private sector also is recommended. The government should consider seeking foreign funding (aid or private investment) for the airport upgrade. In the meantime, flight and pricing schedules should be revised to mitigate some of the constraints on air travel; for example, more commuter flights to Gabon and other countries in the region could be added.

The limited port structure, characterized by small, old quays of shallow depth, and irregular shipping services are hampering the integration of the country into the regional and global markets. The few larger ships that stop at São Tomé are obliged to anchor at sea, with their freight offloaded by smaller boats. This is expensive in terms of both time and money, especially as port handling costs are high. Furthermore, port authority cranes and other equipment are dilapidated and function below capacity. These factors impede private sector development by keeping high the cost of inputs and imported consumer goods. By extension, the costs of living, production, and exports are all affected, making São Toméan products even less competitive in the global market. Growth of sea trade and tourism with Gabon and between São Tomé and Principe will depend also on the improvement of what is presently an irregular and poor service. The public port authority, however, has funds neither for rehabilitation nor for new investments.

Improvements to the port structure and services are essential to promote private sector development, and a study should be made on the costs of building a deep water port. The port authority should be an autonomous entity, with parts of the port operations opened up to the private sector on a competitive basis to encourage better investment in and maintenance of the port structures and better pricing of services. In the meantime, priority actions for the improvement of the port include: (i) simplifying and lowering the fee structure; (ii) retaining a portion of port revenues for capital investments and maintenance of port infrastructure; (iii) instituting a scheduled service to Principe, with reliable vessels and operated by the private sector on a competitive basis with a subsidy, if necessary; (iv) separating the passenger terminal from the freight terminal to reduce opportunities for theft and risk of accidents.

State intervention also is warranted in areas of market infrastructure where shortcomings are limiting the growth of the private sector and where improvements to that infrastructure are beyond the financial reach of the private sector. For example, the production of perishable food crops, fresh fruits, and vegetables for export will require the construction of cold chains,

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57 The government has signed on to the framework of the Yamoussoukro Declaration made by 23 West African countries in 1999 in Côte D'Ivoire on aviation reform in the region and the open sky policy option. The main thrust of the declaration is to liberalize gradually the scheduled and nonscheduled intra-African air transport services to facilitate access to the air transport market in Africa. It allows for a two-track approach. Countries that are ready to liberalize are encouraged to do so, and the others have two years to start reducing the restrictions in the market. The decision also defines the way of granting traffic rights; the setting of tariffs without requirement for approval; the fact that there should be no limitation of capacity and frequency if the increase of capacity and tariff are in conformity with the rules of fair competition; that multiple designation be allowed; standards for safety and security; and the criteria for eligible airlines to comply with the requirement of the operations. A regulatory body has been set up to monitor and supervise the implementation of the policy. The decision does not include a policy for operation between Africa and other regions of the world.

58 In 1996 the port handled about 50,000 MTs of imports and 5,000 MTs of exports. INDES, op. cit., p. 28.
comprising in-field packing centers as well as central market and export terminal cold rooms. In artisanal fishing, the priority is also to have cold storage. This would require the acquisition of ice-making equipment and the building of cold storage rooms at key locations. Electricity, telecommunications, and sanitation also must be improved and a clean water supply provided (Annex III). The building of such key components has been recognized as essential to the promotion of agricultural exports and fish production and is supported by donors elsewhere in Africa.

B. Rural Sector Sources of Growth and Poverty Alleviation

101. Diversifying the sources of rural growth requires further reforms to take the sector beyond traditional agriculture and into high-value agricultural exports, fishing, and livestock.

1. Strategy

102. As cocoa will still be an important agricultural product in the medium term, the PRSP proposes pursuing a two-pronged policy to promote diversification: it is to help improve cocoa quality and productivity to increase its returns, and it is to improve the incentive and support framework to encourage private farmers to make the market-induced shift away from cocoa. This diversification effort would be served best by focusing on relatively small, specialty agricultural production for the high-end export markets (for example, peppers, avocados, oranges, mangoes, and tropical flowers) while at the same time boosting production of staple crops such as bananas, breadfruit, and taro for food security. Such a strategy is consistent with the natural endowments of the country (different soil compositions and micro-climates, hilly terrain, tropical vegetation), the need to increase the revenues of rural producers, and the need to enhance food security to reduce poverty. In Kenya, households which export horticulture products were found to be better off than those which do not, particularly in rural areas. Simulations on poverty suggest that smallholder households switching from non-horticultural production to horticultural production would decrease their total poverty by 27 percent.\(^5\)

103. Given the small size of its population, increased agricultural production could quickly saturate the domestic market. There is a danger that this could stifle vigorous and broad-based agricultural growth. To mitigate this constraint, São Tomé and Príncipe would do best by relying on the product quality continuum along the domestic, regional and international high-end markets. The country should pursue regional integration and EU market penetration. In the longer run, success in these markets could provide a platform for integration into the world economy and help reduce the country’s isolation.

104. Rather than directly involve itself in the production process, the government should consider taking a supporting role in the diversification process. This would involve scaling up its sector-wide funding of capacity building and institutional strengthening (data gathering and analysis, research), regulatory supervision (phyto-sanitary controls), legal and infrastructural

support, and extension (technical and marketing) services. The farmer would choose the crop and acreage under cultivation.

2. **Potential Products for Domestic And Export Markets**

105. There are a number of products that have a potential comparative advantage on domestic and export markets and that fit within the government’s rural development strategy. Clearly, the country’s endowments and the market conditions will determine which of these crops are to be produced. Formal comparative analysis is not possible, however, due to the lack of reliable data.

106. The government would like to help raise cocoa production from its current low of approximately 3,500 MTs per year to the pre-independence level of more than 10,000 MTs. The PRSP sets ambitious targets to this end: to replant 7,000 ha with cocoa in the 2003–08 period and support improvements in its production and transformation technology. Given the health and age of the existing cocoa plants, such a revitalization would require considerable investment and medium- to long-term planning. Funding for this has not yet been identified. Nonetheless, any revitalization should shy away from sheer increase in production volumes/acreages to fit within the agricultural diversification strategy of the government. It should instead focus production and marketing on high-value, niche markets that play to the islands’ comparative advantage: São Tomé and Príncipe’s “fine or flavor” cocoa usually sells at a premium compared to the mass-market cocoa consumed in Western Europe, the United States, and Japan.

107. If this revitalization is to lead to income creation and poverty alleviation, the smallholder sub-sector will require additional state support to become sustainable and efficient. At present there is a glaring lack of supporting extension services, institutions, and market mechanisms to assist smallholders (see below for further discussion). The current marketing system needs to be reformed as it forces the price-taking small farmer to sell “wet” cocoa beans instead of higher-quality fermented and sun-dried beans. Training farmers in better agricultural techniques and setting up a quality standard and testing facility also would help improve cocoa quality and strengthen its market niche and price.

108. The cultivation of food crops such as banana, breadfruit, maize, taro, and other root crops has increased as small farmers have responded to land reform and market signals (Chapter 2). Horticultural products such as spring greens, carrots, cabbage, beans, and potatoes historically were grown in the north and center of São Tomé, and by 1993 the production of vegetables in the region reached 2,000 to 2,500 MTs per year.\(^6\) Increasing food crop yields on land already in production fits in with the government’s goal of achieving food security within the next 20 years, while providing smallholders with potential new sources of income and thereby assisting poverty reduction. To achieve this productivity increase, extension services will need to help train farmers and facilitate the provision of agricultural inputs such as fertilizers.

109. Further diversification in food, fruits, and vegetables (horticulture, fruits, rice, and root crops) could be achieved by rehabilitating abandoned and overgrown cocoa tracks. Cocoa plantations are prime candidates for conversion to fruit trees less susceptible to Thrips. The

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\(^6\) Current data not available. 1993 data from IFAD.
constraints imposed by the small size of the domestic market are already affecting some products, notably taro and other root crops, on a small scale. A coherent analysis and action plan therefore are needed to coordinate the production, processing, marketing, and export of crops to regional and international markets—and particularly to exploit the expanding EU demand for exotic and off-season fruits and vegetables. A successful program would increase the country’s export base, which currently includes the Netherlands (51 percent), Germany (6 percent), and Portugal (6 percent). Table 4.1 gives an idea of the potential EU market for select fruits and vegetables.

Table 3.1: European Union Market for Selected Fruits and Vegetables (2000)

<table>
<thead>
<tr>
<th>Products</th>
<th>EU imports (Mt)</th>
<th>Growth rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Green bean (bulk)</td>
<td>67,614</td>
<td>15%</td>
</tr>
<tr>
<td>Green bean (pre-pack)</td>
<td>16,900</td>
<td>50%</td>
</tr>
<tr>
<td>Cherry tomato</td>
<td>20,128</td>
<td>50%</td>
</tr>
<tr>
<td>Mango</td>
<td>119,093</td>
<td>15%</td>
</tr>
<tr>
<td>Melon</td>
<td>161,056</td>
<td>35%</td>
</tr>
<tr>
<td>Papaya</td>
<td>16,600</td>
<td>100%</td>
</tr>
<tr>
<td>Gumbo</td>
<td>23,500</td>
<td>30%</td>
</tr>
<tr>
<td>Green pepper</td>
<td>15,983</td>
<td>40%</td>
</tr>
<tr>
<td>Sweet potato</td>
<td>13,090</td>
<td>50%</td>
</tr>
<tr>
<td>Ginger</td>
<td>11,928</td>
<td>30%</td>
</tr>
</tbody>
</table>

Source: Eurostat (2000); Senegal Agriculture Export Promotion Project

110. São Tomé and Príncipe also has the natural conditions capable of supporting production of a wide variety of essential oils, spices, and potentially flowers. Some success already has been achieved by a 60 hectare donor-supported agricultural pilot project that produces and exports pepper to Spain. Vanilla and flowers are other possibilities, but a feasibility analysis of production, marketing, and transport channels is needed.

111. Coconut and palm oil are two other crops that potentially can contribute to economic growth in São Tomé and Príncipe. Coconut covers an estimated 8,000 ha, second only to cocoa, and like cocoa has been in decline since the early 1980s due to unfavorable world prices. Productivity is very low, with a large part of the crop produced for domestic consumption. The rest is exported to Europe.\(^{61}\) Palm oil production was approximately 1,000 MTs in 1998, from an estimated 3,500 ha planted—500 MTs short of satisfying domestic demand. Emolve, the main palm plantation, is publicly owned and insolvent and slated for privatization. As in the case of cocoa and coffee, the country’s coconut and oil palm trees are old and low-yielding. To support a feasibility analysis for expansion of these crops, additional information must first be secured on the state of coconut and palm oil cultivation and the country’s processing capabilities.

112. São Toméans note that at one time the coffee beans of Monte Café produced the world’s most expensive and most desired coffee, selling at a large premium above world market prices,

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\(^{61}\) In 1996, 975 MTs were exported, mainly to Europe. There have been allegations, however, of clandestine exports, and no current and accurate data exist.
and sold out for many years in advance. There is also strong local demand for this coffee. As of the late 1990s, coffee covered approximately 1,000 ha, some in rural areas but mostly at the Monte Café plantation. Productivity declined considerably over the 1990s, with production reaching only 44 MTs in 1997 and 36 MTs in 1998, despite large investment during the same decade. As with cocoa, São Toméan coffee retains considerable goodwill. The fertile volcanic soils, high elevation, and climate are ideal for high-end, specialty coffee production for the export and local markets. A drawback is that because coffee has been out of favor much longer than cocoa, its plants tend also to be much older. Coffee production requires more care and ultimately more resources than cocoa, so that only a high-value coffee, with a good price premium, would merit production by local farmers.

The PRSP plans to provide support to the small producers (family agriculture) to plant 1,000 ha of Café Robusta or Arabica by 2010, doubling the area under cultivation. In the short term, to turn coffee into a source of income for farmers it would be necessary to increase productivity through the use of technical improvements. A review of the land distribution process (land re-dimensioning) at Monte Café also would be useful.

Artisanal fishing is already a key source of protein and income in spite of severe constraints that limit fish catches, restrict fishing because of conservation, and constraints on distribution. Few artisanal vessels are equipped with outboard motors; as a result most cannot go further than 10 miles (16 kilometers) from the coast. The relatively high cost of gasoline (some 50 cents a liter in 2003), furthermore means that those fishermen with powered boats must limit their time at sea. The government and donors from Japan and the Taiwan Province of China provide support to small fishermen and their buyers through financing schemes. In the medium term, the PRSP’s objective is to increase the amount of catch to guarantee food security. Its list of priority actions includes the importation of fishing equipment, provision of credit to artisanal fishermen, and popularization of new pirogues and fishing techniques. However, the government also needs to address the infrastructural and institutional problems in the sub-sector. These range from a lack of physical structures such as cold storage facilities and adequate roads to a lack of market information and adequate extension services. The resources for industrial fisheries additionally are limited by the narrow continental shelf; therefore the deep-sea tuna resources of the Gulf of Guinea and shellfish in the coastal waters consequently represent the best hopes for fishing exports.

Animal production by small farmers supplements crop revenues and provides a hedge for crop failure. The country’s small size, rugged landscape, and humid climate favor development of poultry, swine, and small ruminants, and these could increase the source of income and availability of protein for both rural and urban poor. The carta politica (rural development strategy) envisions growth based on family farms and medium-sized enterprises. There are potentially 3,000 ha of pasture in the northeast of São Tomé island that could be exploited for family farms. Poultry and swine are clearly the lowest-cost activities, in terms of acquisition and

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62 During the 1990s 150 hectares of the old plantations were rehabilitated and 700 hectares were replanted with arabica coffee bushes. A coffee treatment unit with an annual capacity of 1,000 MTs also was built (Carta Politica, 1999).

63 In 2002, a liter of gasoline cost 4,500-4,750 dobras.
operational costs. In the commercial sector, it is envisioned that medium-sized farms could produce goats, swine, and some cattle to provide meat for the urban population. There is little government support for this sub-sector, however, especially in the critical areas of sanitation and veterinary assistance to smallholders.

116. There are several prerequisites for success in the livestock sub-sector. These include increased phyto-sanitary and epidemiological control over production; the establishment of privatized and decentralized veterinary services for smallholders; the provision of extension services and technical support to producers; and the provision of subsidized inputs, especially veterinary products. Rehabilitating the capital’s slaughterhouse and building smaller, hygienic ones in other locations also would ensure better sanitation in the production chain.

3. Institutional Support and Extension

117. For diversification and rural development to take hold, farmers need high-quality, consistent institutional support from governmental entities, NGOs, and producer associations. This support should encompass agricultural research and extension, training, and marketing information.

118. At present, the institutional support is weak. A new ministry of agriculture and fisheries was created in late March 2002, consolidating oversight over all entities related to the sector, including: CIAT (research), CENFOPA and CATAP (training), the Office of Agrarian Reform, the Office of Planning and Evaluation, and the Directorate of Agriculture (extension).

119. CENFOPA and CATAP have limited resources. CIAT (Centro de Investigação Agronômica e Tecnológica) is responsible for performing research and experiments in the agricultural area and communicating these results to the appropriate extension and dissemination organizations. Again, it is operating with insufficient resources. There are no reliable data being collected and analyzed on the agricultural sector, with the result that even simple information, such as the change in cocoa acreage and trends in yields, is not available. Nor are formal comparative advantage studies available to support assessment of the potential sources of growth discussed above. NGOs have at times substituted for public institutions, and in this respect have an advantage over public institutions in that they can provide communities with services and a voice to more effectively make their needs known. Producer organizations (FENAPA for small farmers and ASPAP for medium-sized and large enterprises) also can represent the rural population and provide services in the context of a liberalized economy.

120. A larger budget and higher capacity for the Ministry of Agriculture would have a positive spillover effect on services rendered to farmers. A first step would be to reestablish funding to upgrade CIAT’s capacity for data collection and analysis. The statistics that CIAT collects provide basic information on the status quo. CIAT’s role in industrial crop research (e.g., of new techniques, better hybrids, pest control, and post-harvest processing) and phyto-sanitary controls and regulations could prove very useful in testing and certifying that export products meet the norms and requirements of European and other developed countries. This research and extension is especially important for reestablishing the quality and productivity of cocoa and coffee and to promote agricultural diversification. It is also fundamental in ensuring that any new varieties are
suited to the climatic conditions of the islands, that appropriate agricultural techniques are used, and that soil fertility is maintained.

121. CENFOPA and CATAP should focus on preparing *tecnos superiores* for courses of study outside the country. It is also important, via short courses, to retrain workers and "extensionists" who are already in the labor force.

122. Agricultural growth and rural development cannot be achieved without the active participation of the rural population. Better coordination between the government programs and the NGOs that do provide support, for example, in financial services, input supply, extension, marketing, or rural handicrafts, would enhance the effectiveness of their work.

C. Tourism

1. Government Goals and Strategy

123. The PRSP considers tourism to be one of the major sources of diversification and income creation for the economy in the medium term.\(^{65}\) As outlined in its tourism strategy, the government’s goal is to welcome 25,000 visitors per year by 2010 (20,000 tourists and 5,000 business travelers). Projections show that such a goal would translate into:

- An increase in tourist traffic to approximately 10-15 percent of the national population. The impact of this would need to be carefully monitored.\(^{66}\)
- Environmental protection being necessary for sustainability of the flora and fauna of the islands; preemptive steps should be taken to mitigate against damage.
- A need for 350 more hotel rooms.
- The creation of 1,460 jobs by 2010, including 700 direct, 60 indirect, and 700 induced or spillover.
- Hypothetically, the generation of US$21 million per year,\(^{67}\) or 4.4 percent of GDP. This would represent a doubling of the estimated share of tourism in GDP compared to 1999.

124. The goal of reaching 25,000 tourists per year is ambitious. Whether the government pursues this goal or settles for a smaller number of visitors, it needs to ensure that its development strategy is environmentally sustainable--particularly as the islands’ comparative advantage in this sector is its endemic flora and fauna.

125. The government’s tourism strategy is a mixed approach, combining adventure/sports/ecotourism with some beach/resort tourism. The country hopes to acquire a niche in the high-

\(^{64}\) Information for this section was taken mainly from the 2001 World Tourism Organization draft Tourism report for São Tomé and Príncipe.

\(^{65}\) PRSP, December 2002.

\(^{66}\) This ratio is 22.2 in Cape Verde. In Mauritius it reached 54.6 and in the Seychelles 162 percent in 2000.

\(^{67}\) This is based on the assumption that business clients will stay five days and tourists will stay 10 days.
end, individualistic tourist segment. Pure beach/resort tourism is a highly competitive segment of the industry, and São Tomé and Príncipe would not fare well in it, as the quality of its beaches is lacking and the cost of traveling to these beaches would be high. Furthermore, mass tourism involving daily ship arrivals or traditional beach tourism would not fit with the country's sustainable development goals. The addition of adventure/ecotourism, however, could produce a win-win situation for economic growth, poverty reduction, and the protection of the environment. Such tourism could include trekking in the rainforests, fishing, scuba diving and snorkeling, and cultural tourism in rural areas and to architectural sites. Adventure/ecotourism could involve the local population in income-generating activities such as guides, hospitality service providers and park wardens, and could provide the incentive to participate in managing and protecting the natural resource base and historical sites.

126. The country should adopt a multifaceted marketing approach to attract tourists. It could market to regional tourists (nationals and non-nationals) residing in Gabon, Nigeria, or Angola, in search of spots for short vacations. Given the isolation of the islands, it also should market the country as part of a regional package. São Tomé and Príncipe may be difficult to develop as a primary destination, but fits in well with the profile of a complementary stop-over destination en route to destinations in Southern Africa or on the Gulf of Guinea. Short-stay visitors furthermore tend to contain their visits to a few sites that can be readily monitored. While any environmental damage is thus concentrated and potentially more serious, it also should be more readily contained. Short-stay tourists spend less, however, and their economic impact on employment and poverty reduction would be less. Any efforts to attract tourists for a longer, 8–10 day stay may be best directed to the European market, especially to Portugal and France for their historical, cultural, and linguistic ties, but also to countries such as Germany, Switzerland, and Austria, promoting the islands’ tropical weather and environmental attractions.

2. Tourism Strategy

127. For the Tourism Strategy to succeed, three sector-specific constraints need to be addressed. An improvement in health conditions and services is a necessary investment for the growth of the tourism sector. The prevalence of infectious and transmissible diseases—such as malaria, acute respiratory infections, and diarrheal diseases—is a major obstacle to tourism, and in mid-2003 the government launched a campaign to fight malaria. Furthermore, the city of São Tomé and its beaches urgently need sewage treatment and better garbage collection facilities. The unprocessed city sewage runs directly into the ocean, often near city bathing spots. These conditions create a hazardous health environment for the nationals, and make the city and its beaches largely unattractive to tourists (Annex III).

128. The institutional structure and capacity supporting the tourism sector is weak. In April 2002, a government reorganization combined commerce, industry, and tourism under one ministry. This will hopefully result in the sector achieving more active support than in the past. The Directorate of Tourism nonetheless is composed of a small office staffed by just eight civil servants, whose job it is to plan the development of the tourism sector and evaluate individual development plans and promote and regulate the sector. An intergovernmental advisory group (CITUR) is responsible for coordinating action and concerns among ministries affected by tourism. A consultative group to CITUR provides it with necessary support.
129. A larger tourism office, staffed by trained professionals, would be better able to thoroughly analyze the needs of the sector and the viability of investment projects. Strengthening the sectoral regulatory and supervisory capacity, especially environmental protection measures, would ensure more sustainable development of the sector. Training, furthermore, should continue right down the scale--basic school education or on-the-job training is inadequate for a sector that encompasses hostelry and the diverse leisure and service industries that are related to tourism.

130. Air transport quality and price improvements are critical to the development of the sector. The government should consider short-term alternatives to the expansion of the airport, which is a medium-term project. The feasibility of arrangements such as chartering, more frequent flights of smaller planes, opening the market to new airlines (such as the Air Luxor biweekly service), and integrating São Tomé and Príncipe into the regional market need to be studied to enable the country to take full advantage of its proximity to other tourist destinations such as Gabon and Senegal.
4. KEY DEVELOPMENT PRIORITIES AND CHALLENGES

131. The Poverty Reduction Strategy Paper is anchored on the rapid and broad-based growth of a diversified and liberalized private sector-driven economy to alleviate poverty. Chapter 3 discusses the private sector-specific conditions and policy measures needed to bring about the PRSP goals. On a wider policy spectrum, the PRSP proposes restructuring the role and reach of the public sector and reducing its presence in economic activities, as well as focusing it more on functions that are inherently public in nature. It nonetheless is clear that the government will retain a major role in facilitating private sector development, economic growth, income creation, and poverty reduction. Institutional, legal, and regulatory reforms and capacity building would reinforce the market economy such that its agents could respond adequately to the incentives signaled by prices. In achieving the ambitious goals of the PRSP, three key development priorities stand out: (i) enhancing support for human resources development; (ii) improving public sector management; and (iii) reinforcing institutional capacity and governance.

A. Pursuing Human Resources Development

132. The Poverty Reduction Strategy identifies human resource development as a central priority for the economic growth and poverty alleviation strategy of the country as a healthier and more educated population is more productive and more highly paid. The health and education outcomes discussed in Chapter 1 highlight the urgency of government action to address institutional shortcomings, quality, access problems, and expenditure structures of these sectors.

1. Health

133. Institutionally, weak managerial capacity (planning, budgeting, and monitoring activities) seriously hampers the general performance of health services. The lack of human resource management translates into lack of motivation in the workforce. Despite a recent increase in personnel and training, there are still serious shortages of staff quality and quantity.

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68 The PRSP outlines six major objectives that will lead to a gradual development process in favor of the poor. These are: (i) growth and diversification of production; (ii) guarantee of alimentary security; (iii) improvement of the socioeconomic conditions of the rural and urban populations as well as of the population in transient zones; (iv) conservation of national resources; (v) promotion of women and young people; and (vi) promotion of exports of goods and services. The government has also identified the five axes through which it plans to achieve the PRSP goals: accelerated and redistributive growth; the creation of opportunities for increased and diversified returns; human resources development and access to basic social services; reform of public institutions, capacity building, and promotion of good governance; and mechanisms for follow-up and evaluation of the strategy.
Furthermore, health staff are concentrated in tertiary institutions and in the capital district, and there are very few national specialists or public health specialists.  

134. São Toméans overall have access to health care, but the quality of service is lacking. With one doctor for 2,000 inhabitants in 1998, the country has one of the lowest ratios in Sub-Saharan Africa. Ninety-one percent of the population lives within a one-hour walk of a health facility, but the actual level of service delivery in primary health care (PHC) is very low because of aging infrastructure and serious shortcomings in staffing, drug availability, and technologies. To promote PHC with equity, the minimum health package (MHP) concept was elaborated by the World Health Organization and the World Bank. In practice, however, the MHP is not effectively implemented in the National Health System.

135. Expenditure management in the sector needs to be improved. In the mid-to-late 1990s, public expenditure in health varied from 9 to 19 percent of the overall budget, corresponding to 6 to 10 percent of GDP. In 1999 per capita expenditure in health was US$30, a relatively high amount compared to many African countries. However, budget has had an ad hoc nature, defined by availability of funds rather than by a coherent plan for meeting the population's health needs. In the late 1990s, fund allocation within the system, furthermore, went contrary to the announced PHC priorities--again, a sign of poor management. According to estimates from the Ministry of Health, annual per capita drug consumption is US$1.80, or less than US$250,000 per year. The population participates in payment for drugs and ambulatory treatment, but cost recovery efforts have not been successful and there are no private insurance mechanisms in the country.

136. There is also no national policy for drug supply management or for the acquisition and maintenance of equipment and health technologies, which are essentially provided by donors. There are frequent drug stock interruptions due to the country’s fragile economic situation and poor management; the most peripheral health units as a result are frequently without essential drugs. In response, a drugs fund (Fundo de Medicamentos) was created in 1998 with the support of UNICEF and WHO to import, stock, and commercialise all drugs for the health system. It was also conceived as a mechanism to promote the Bamako Initiative, thus facilitating cost recovery, and to induce community management of health posts. However, in most cases, the process was plagued with high operational costs and poor cost recovery, rendering restocking difficult.

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69 Out of the approximately 1,000 employees of the Ministry of Health, some 48 percent are in the tertiary institutions, 43 percent are in the district health services, and 9 percent are in the central services. Fifty of the 77 doctors reside in the capital district, where the main hospital is, as do a similar proportion of other professionals.

70 The MHP is a minimum set of promotional, preventive, and curative activities to be provided in an integrated way at each level of the system. The components of the MHP being implemented in the country are: information, education, and communication in relation to the predominant health problems; nutrition; water and sanitation; reproductive health, including family planning, vaccination against the predominant infectious diseases; adequate treatment of common illnesses and trauma; and essential drugs. The MHP is specifically defined for each level of the health system and the programs most directly involved in its design are disease control, particularly malaria control, and reproductive health, including the EPI (extended program on immunization) and mother and child health.

71 In 1995, more than 81 percent of total budgetary expenditure went to district and community activities. In 1999 this percentage was reduced to only 22 percent.
137. The role of the private sector in health provision is very limited, but a small number of poorly equipped and poorly managed clinics do exist. Some NGOs are involved in health care delivery, in particular in the districts of Mezochi and Cantagalo, where the Instituto Vale Flor plays an important role in ensuring health care. There are no visible efforts for effectively regulating and monitoring these activities.

138. The government embarked on a health sector reform process in 1999 to address the inadequacies and imbalances of the health services, formulating a health policy (HP) and in 2000 to 2001 a National Health Development Plan (NHDP) to implement the HP. The *carta sanitária* (health infrastructure map) was also developed. The NHDP identifies 6 main programs, costed at US$24 million over 5 years, but does not identify the source of funding or priority actions, given institutional, human capacity, and financial constraints. While the NHDP matches the PRSP goals, neither the HP nor the NHDP mention the MDGs to which São Tomé and Príncipe subscribes and which therefore should constitute reference indicators.

139. Only one quantitative health objective is defined in the PRSP: that the share of health expenditure in the government budget remain at 13 percent over 2005–2015. This goal is reachable as the health share was 12 percent in 2000 and 14 percent or higher in 1999, 2001, and 2002. Sustainability of the goal will depend on the government’s commitment to health and education, on macroeconomic conditions, and on budgetary discipline.

**Recommended Actions**

140. In the short term, the PRSP health targets urgently need to be completed and finalized. It would be useful for the authorities to review the HP and NHDP to prioritise goals and to match them with the final PRSP health targets and the millennium health goals.

141. There is also a need for the strategy and action plan to strike a balance between the country’s needs and what is feasible in the medium term given the financial (for example, the PRSP’s MTEF) and human resource constraints.

142. A national strategy needs to be elaborated, costed, and adopted for the pharmaceutical policy. The HP provides a development plan outline, with expected outcomes and timed actions to be taken. However, none of the actions have been launched, as the first step in each plan, developing the strategy, has not yet been undertaken.

143. The sector needs a more developed policy for human resource management to ensure that the goals of the HP—systematic training, professional development, and better salary structure—are achieved. The HP outlines only a human skills development plan, providing a brief

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72 The health policy identifies a large number of priorities, including disease control, with an emphasis in malaria, tuberculosis, and sexually transmitted diseases including HIV/AIDS; reproductive health (women’s health, child health, and youth health); non-transmissible diseases (nutritional diseases, mental health, and cardiovascular diseases); health of the elderly; IEC and environmental health.

73 These six programs are: institutional strengthening; health care delivery; human resources development; strengthening the health network infrastructure; pharmaceutical sector development; and strengthening the Health Information System (HIS).
discussion and actions to be taken. Special emphasis needs be placed on the need to strengthen the managerial capacity in the sector.

144. The NHDP should emphasize clearly the minimum health package (MHP) as a strategy to bring health care to every citizen. Adopting a systematic approach in implementing the MHP could provide a practical way to foster primary health care implementation and to improve health care delivery at all levels of the system.

2. Education

145. The management of the education system is centralized, with almost all managerial functions concentrated in the Ministry of Education. Partnerships with municipalities, NGOs, and local collectives are underdeveloped. The system has a shortfall of capable managers, particularly in planning, administration, monitoring and evaluation. The sector thus suffers from a lack of adequate financial planning, sectoral analysis, and effective decision making, leading to poor resource allocation and performance. There is no information system for collecting background data on performance, families, communities, or community participation in the educative process. Other educational inputs such as equipment, school manuals, and textbooks are scarce and of low quality. Many curricula and school manuals are outdated, some by 20 years.

146. Motivating and training teachers is a cornerstone to improving the educational system. Low salary levels, the absence of a career perspective, and lack of motivation have made teacher retention and the provision of quality education difficult. There is consequently a shortage of properly trained teachers. In the 2000-01 school year, 60 percent of primary school teachers and 45 percent of all teachers were without qualifications. Teachers earn only 1.5 times the GDP per capita, much less than do their counterparts in English- or French-speaking African countries (2.4 times GDP per capita and 6.3 times GDP per capita, respectively). The current strategy of training a small number of teachers in a limited number of subjects for the secondary level may not be adequate because of orientation, training time, and costs.

147. Both access to and the quality of the educational system need major improvements. An analysis of enrolment rates shows a falling trend in overall school enrolment, from 59 percent in 1991 to 53 percent in 1999, despite the growth of the school-age population. This is due to a drop in primary school enrolment and a simultaneous increase in the number of school-age children (7 to 10 year olds) who were out of school. In 1991, 3.7 percent of school-age children were out of school compared to 20.6 percent in 1999, in direct contrast to the world trend. The poor retention rate can be partially attributed to poverty, as families keep their children at home to help with work.

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74 In the 1990s some investment was made with a view to overcoming this situation. The African Development Bank financed the training in Portugal of some 30 teachers and the construction of a Teacher Training School. The project did not produce the expected results (Data from Department of Education data sheet, May 2002).
75 Background CEM chapter on Health and Education, Carlos Tiny, 2002.
76 At the pre-university level, the rate stayed stable at 20 percent between 1994 and 1999 (Data respectively from Ministry of Education of São Tomé and Príncipe and “Report on the Education in the World,” Dakar 2000).
148. The system also needs to address its very low internal productivity. Overall, at least one-third of resources invested in the system is estimated to be failing to produce the expected results. In São Tomé and Principe, seven years of education are assessed as necessary to ensure that children acquire an irreversible base of knowledge, sufficient for them to lift themselves out of poverty and contribute to economic growth. An estimated one-third only of each entering class achieves this minimum base of knowledge. Out of 100 students entering the first year of schooling, 78 will finish the primary cycle (Y1 to Y4), and 29 will conclude Y8 (the basic secondary cycle). Only 17 will reach the high end of the school pyramid, completing pre-university (Y11) education.

149. Gender and poverty issues also need to be specifically addressed by the educational system. Data indicate that the number of girls not attending school is higher than that of boys: in 1997, girls constituted 54 percent of all non-attending children. The disparity is due to the fact that girls are more often kept at home to help around the house and with younger children. Analysis and projections in the sector furthermore usually deal with aggregates, and rarely (and only minimally) focus specifically on the situation of the poor and marginalized or on gender issues. It is implicitly assumed that if the system operates “well” it will deal adequately with poverty, which is not the case. The PRSP recognizes this weakness and highlights the importance of ensuring equal access for women and the poor.

150. The learning time also is insufficient and repetition rates are high. The school year is 36 weeks, including evaluation time and other preparatory activities. The multiple shift regimen prevalent in many schools and districts furthermore reduces actual learning time per student to 2.5 to 4 hours a day, and the existence of triple shifts and double shifts indicates disparities between different districts. The low quality and efficacy of the education system also translate into high repetition rates: 27 percent for primary students (Y1–Y4), 32 percent for secondary (Y5–Y8), and 28 percent for pre-university (Y9–Y11). It takes an average 5.2 years for a child to complete 4 years of basic education (Y1–Y4).

151. Future public expenditure in the education sector would benefit from analysis and reorientation. Table 4.1 points to a sustained increase in public expenditure funding since 1996. In 2002 the government dedicated 8.2 percent of public funds to education and, in 2003, 11.6 percent. However, only 2003 expenditure levels (5.5 percent of GDP) are higher compared with those of other African HIPCs, which spend an average of 4 percent of GDP on education. The allocation of resources within the system furthermore contradicts the policy guidelines on supporting primary education. The share of public expenditure for schooling and allocated to primary education from 1991 to 98 decreased from 52 percent to 38 percent.

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77 55 will reach Y5, and 47 will reach Y6.
78 Many schools function on a multiple-shift system due to a lack of classrooms, qualified teachers, and funding. In 2000–01, 43 percent of primary students were taught under a three-shift regimen, and some 64 percent of secondary and pre-university students faced two-shift schooling.
79 Rakotomotala et al., 1999.
80 The main sources of funding have traditionally been the national budget, bilateral and multilateral donors, NGOs, churches, and communities.
152. Despite low teacher salaries, some 65 percent of the education budget goes to remuneration, and the remaining one-third of the budget is insufficient to maintain infrastructure and purchase school equipment and teaching materials. In recent years, there have been large investments, mostly donor-supported, to renovate schools, build new classrooms, and produce school manuals but, as the educational network is under continual use without any consistent maintenance, the system continues to suffer from inadequate and low quality infrastructure.

Table 4.1: Share Held by Education of Current Expenditure

<table>
<thead>
<tr>
<th>Year</th>
<th>In Billions of dobras</th>
<th>As % of current govt. expenditure (debt not included)</th>
<th>As % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>1.2</td>
<td>6.8</td>
<td>1.2</td>
</tr>
<tr>
<td>1997</td>
<td>3.0</td>
<td>11.0</td>
<td>1.5</td>
</tr>
<tr>
<td>1998</td>
<td>5.4</td>
<td>12.4</td>
<td>1.9</td>
</tr>
<tr>
<td>1999</td>
<td>7.4</td>
<td>15.5</td>
<td>2.2</td>
</tr>
<tr>
<td>2000</td>
<td>8.3</td>
<td>15.3</td>
<td>2.2</td>
</tr>
<tr>
<td>2001</td>
<td>12.8</td>
<td>11.4</td>
<td>2.7</td>
</tr>
<tr>
<td>2002</td>
<td>13.1</td>
<td>8.2</td>
<td>2.7</td>
</tr>
<tr>
<td>2003</td>
<td>21.8</td>
<td>11.6</td>
<td>5.5</td>
</tr>
</tbody>
</table>


153. The government adopted a new educational structure in 2000, but has not implemented it due to a lack of finances and capacity. This new structure defines as mandatory education for children aged 7 to 12 years (Y1–Y6); the preschool subsystem and the secondary and higher education modules are voluntary. The new structure also addresses non-school education (adult literacy, professional education, distance learning and special education). It has two notable drawbacks: it does not clearly account for either professional training or teacher training. Both are crucial weaknesses in the São Toméan educational system.

154. The I-PRSP and PRSP documents include a planned redirection of policy priorities and spending. For São Tomé and Príncipe, the PRSP goals relating to literacy, the net school enrollment rate (or the millennium development goal of universal primary education by 2015), and primary school ratios of students to teachers, students to classrooms, and groups to classrooms should be achievable in 2005 and beyond, given the country’s low population growth and assuming the provision of sufficient institutional and financial support (Table 4.2).

155. Achieving better training and certification of teachers is a project for the medium term, requiring planning and sustained funding. The 2005 dateline to achieve a 60 percent certification rate appears therefore optimistic. Achieving consistency over a period of 12 years of the budget’s percentage share dedicated to education (17 percent) will depend on the government’s commitment to the sector, its budgetary discipline, and macroeconomic stability.
Table 4.2: Selected PRSP Educational Goals

<table>
<thead>
<tr>
<th>Overall Goals</th>
<th>2001</th>
<th>2005</th>
<th>2010</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Literacy rate of youth and adults (%)</td>
<td>80.7</td>
<td>85</td>
<td>95</td>
<td>100</td>
</tr>
<tr>
<td>Net primary school enrollment rate</td>
<td>79.8</td>
<td>87</td>
<td>97</td>
<td>100</td>
</tr>
<tr>
<td>Ratio students / teachers (2002)</td>
<td>33</td>
<td>30</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>Ratio students / classrooms</td>
<td>31</td>
<td>30</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>Ratio groups / classrooms</td>
<td>2.1</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Teachers with academic titles (%)</td>
<td>45.5 (2002)</td>
<td>60</td>
<td>70</td>
<td>80</td>
</tr>
<tr>
<td>Share of educational expenditure in the budget</td>
<td>10.8 (1999)</td>
<td>17</td>
<td>17</td>
<td>17</td>
</tr>
</tbody>
</table>


156. The educational reform process is much less developed than that of the health sector. In 2000 the Ministry submitted to the government an Education Policy and Strategy Paper (EPSP). The government developed and costed an education strategy in 2003 but has not adopted it yet.

Recommended Actions

157. The education strategy needs to be adopted and implemented. The strategy needs to fit with the PRSP educational goals and should include the millennium goal associated with the promotion of gender equality. The carta escolar (school mapping) should guide future intervention in the school infrastructure network.

158. In-depth institutional reform should address extensive capacity building at the managerial (management, planning, and evaluation) and teaching levels to improve the efficacy of the system. Management of the sector should be decentralized and partnerships with municipalities, parents, communities, and NGOs strengthened. The strategic plan must lay out a course of action and costing of a cogent overall approach for training/professional needs.

159. Basic education is a stated priority in the PRSP, but is especially important that the educational strategy be geared to market demands, to address the high unemployment among young people. The system should provide traditional secondary education and schooling specifically to equip students for employment in technical and professional fields, where there is a strong demand from the private sector for skilled labor. The strategic plan outlines this need and inclination, but it does not identify how this plan is to take effect, whom it would target, nor how it will be funded. One suggestion is that revised programming at the Instituto Superior Politecnico could provide tertiary-level education/training in a selected number of science and technology subjects to fill this market demand.

B. Improving Public Sector Management

160. The government recognizes the need to strengthen its overall supervisory capacity and to improve transparency and efficiency in its tax collection, budget implementation, and expenditure supervision processes. Public sector reform and capacity building, especially in preparation for the financial and economic management of the future petroleum revenues, also are urgent. Until oil revenues begin to be realized, the country will continue to depend heavily
on domestic revenue mobilization and on donor financing, interspersed by bonus payments on petroleum contract signatures.

1. Tax Reform and Revenue Mobilization

161. Tax reform and revenue mobilization are key elements in the government’s efforts to improve economic management. The economy is dominated by small and informal economic actors, the tax base is narrow, the tax codes date back to 1993 and are amended with a patchwork of addenda, and the tax administration is weak. There is no systematic, broad-based implementation of tax regulation, with the consequence that collection rates are poor.

162. The goal of the government is to move over time from a reliance on trade taxes to income and consumption taxes, while simplifying tax administration and increasing the implementation power of the tax authorities.

163. In 2003 the government launched an embryonic sales tax on services. The new taxes affect only a few large companies, but they are expected to evolve into a value-added tax (VAT) in the future. The government also introduced a single taxpayer identification number for all revenue agencies. These reforms are expected to have a number of beneficial outcomes on the implementation of the tax laws and the collection rate, by improving the monitoring of taxpayer compliance; providing information regarding economically active entities; helping coordination within the public finance framework; further formalizing economic activity; and reducing the tax burden on the few formal firms as tax coverage increases.

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81 Given the degree of informality of the economy and high import penetration, the sales tax will have an impact generally similar to a VAT, and was originally collected at customs.
164. As part of the reform process, the government discussed a new draft tax code in 2003. The draft includes the majority of the FIAS 2001 report recommendations (Box 4.1). The government additionally should consider further revisions to rationalize the licensing procedures and eliminate alvaras (registrations). The need for an export processing zone (EPZ) law and incentive package is also questionable given the tax, administration, and customs reforms underway. The government may wish to consider eliminating the EPZ law and incentives.

165. While the reforms are on the right track, progress has been slow, due mostly to a lack of capacity and the administrative deadlock caused by political uncertainty in 2001–02. To modernize government revenue collection before the prospective petroleum era, the pace of reform and capacity building needs to be accelerated; adoption of the tax code (including the investment code) and improvement of the capacity to implement this particularly need to be expedited.

166. The formulation, execution, and monitoring of expenditure needs to be improved. Budget formulation is still done on a yearly basis instead of within an MTEF. However, the 2003 budget, which was presented to the assembly in December 2002, incorporated some of the PRSP goals and the macroeconomic targets agreed to with international partners. A functional budget nomenclature needs to be adopted, as currently it is not possible to track specific expenditures such as those made on primary or secondary education. Using the PIP as a base at the early stage of budget programming is acceptable. However, the PIP budgeting process should itself be reviewed to better program multi-year investments, in line with the PRSP priorities. The process should list the recurring costs of investments and, to facilitate unification

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Box 4.1: The Existing Tax System and Suggested Reforms

While there are some 3,600 taxpayers identified, the true tax base is composed of approximately 100 enterprises, with a few large firms, such as CST Telecom, ENCO, and Hotel Miramar, carrying most of the tax burden. In 2000, import tariffs provided 52 percent of government revenues, and total tax collection the remaining 48 percent. Fiscal evasion is pervasive: one estimate places actual tax collection at 35 percent of expected collection.

Firms with net incomes of less than 12 million dobras (about US$1,600) pay 30 percent in tax; beyond this threshold, the rate increases to 45 percent. Small enterprises pay a minimum flat tax.

A 2001 FIAS report identifies three major drawbacks to the existing tax system. First, at 45 percent the income tax rate is higher than international norms and is a heavy burden, especially in the services sector. Second, the tax system is complex and costly to implement in human capital and financial terms. Third, the government lacks the institutional capacity and legal implementation instruments to apply the existing tax code.

The report identified potential simplifications to the tax structure while protecting the fiscal intake of the government. The main recommendations are represented in the new draft law and include:

1. Reduction of the income tax (imposto sobre rendimentos) to 25 percent.
2. Complete removal of the minimum value tax (valor mínimo).
3. Removal of the contribuição predial urbana (CPU or urban land tax).
4. Rationalization and simplification of the licensing procedures, as these constitute an impediment to formalization of the private sector, imports, and exports.
5. Cancellation of the Export Processing Zone law and incentives.

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83 The taxes that form 48 percent of government revenues are: tax on income, consumption tax, tax on individual income, and other taxes, respectively contributing 12 percent, 12 percent, 16 percent, and 8 percent of total government revenue.

An exception is made for the agriculture sector, where only 50 percent of net income is imposed.
of the budget, should adopt the same budgetary nomenclature and identification methodology for the programs and projects as does the Budget Directorate.

2. Quality of Expenditure: Formulation, Execution and Monitoring

167. Budget execution is weak. The Directorate of Treasury lacks instructions or procedure manuals for executing the budget. The service lacks a double ledger accounting system, and merely registers payments; the actual treasury operations are done at the Central Bank. As a result, the Directorate of Treasury cannot provide information on balances or whether expenditures are made outside normal procedures. The computerized system at the Treasury needs to be optimized as it is not integrated and thus permits the creation of duplicate data entries, making it prone to error. Moreover, the lack of coherence across stored data leaves doubt as to their reliability and affects the transparency of the budgetary execution process. An accounting program is essential for modernizing the practices of the directorate and consolidating fiscal data. A related reform would be creation of an accounting post within the directorate to take over treasury operations from the Central Bank, keeping the centralized bookkeeping at the MoFP, and preparing the monthly treasury balances.

168. Public expenditure monitoring is inadequate as the government lacks the necessary capacity to undertake thorough internal control of the budgetary process, both fiscal and financial. At present, the budget sub-directorate has regulatory oversight via ledger verification, and the treasury controls effectiveness by checking the delivery. However, the much needed, ex ante financial control is done on an ad hoc basis and needs to be formalized. One improvement would be to incorporate ex ante financial control at the stage following credit approval and before taking an expenditure engagement. Ex post financial control is non-existent. There is little intervention or oversight from the Inspection Générale des Finances, and external controls were basically non-existent until mid-2003 when the Accounting Tribunals started their auditing work. Strengthening the nascent office of the Inspection Générale des Finances with financial verification training would reinforce post-expenditure financial control. Finally, the National Assembly should oversee the execution procedure of the budget that it annually approves.

Recommended Actions

169. The government’s continuing institutional and tax policy reforms should play a key role in improving economic and public sector management, and enhancing supervisory capacity. In the short term it should: (i) promulgate the new tax and investment code immediately to provide the appropriate fiscal incentives for private sector growth; (ii) review the quality of expenditure which would improve budgetary supervision and control; (iii) introduce an integrated computerized information system within the Ministry of Planning and Finance and with the Central Bank for better governance and transparency of the financial/budgetary system; and (iv) institute a systematic ex ante financial control at the stage following credit approval and before taking an expenditure engagement and, posteriori control by reinforcing the Inspection

In the medium term, adopting an MTEF (three-to-five-years) could help the government regularize and program its budgetary and project aid flow more efficiently and with a clearer overview of its development goals. Institutional capacity building needs should be identified and fulfilled over the medium term at the ministerial level rather than at the unit level. This would provide more coherence and coordination with donors.

3. Petroleum Revenue Management

The country’s public finance management skills and discipline will be further challenged with the expected signature bonuses from petroleum in 2005 and a more steady revenue flow in 2010-2012 if oil is struck and production begins. The government is still ill-prepared for the governance and administrative issues that inevitably will arise as the country enters an oil era. São Tomé and Príncipe lacks the policy and legal frameworks, and institutional and technical capacity to address the birth of a major sector. If the prospective oil revenues are not managed with transparency and forethought on the long-term plans of the country, their potential benefits will be unavoidably dissipated.

In anticipation of this fundamental economic change, the government should heed the typical issues that have arisen in many other petroleum producing nations (Appendix IV provides further elaboration on this subject). First, the volatility of oil revenues often creates an unstable, stop-go, budgetary pattern and economic performance. Second, the concentration of the rents in the fiscal authority also tends to weaken the incentives for budgetary restraint and transparency, leading to over-expansion of government and misallocation of resources. Third, the petroleum revenue windfalls are often mismanaged, as there is a tendency to over-spend during booms caused by rising oil prices. When the oil prices drop, the country is left worse off than before due to loss of competitiveness of the non-oil sectors (also known as Dutch Disease). Revenue mismanagement is compounded by the country’s lack of sufficient absorptive capacity, which then leads to poor quality projects.

The key to avoiding some of the economic difficulties discussed above is to “smooth” expenditure via a stabilization or savings fund to share the proceeds of the offshore revenue between current and future generations.

The benefits of expenditure smoothing are four-fold: (i) insulation of the economy from the effects of the petroleum boom-and-bust cycle; (ii) mitigation of permanent production and price shocks, thus providing a more predictable and favorable investment climate for the private sector; (iii) helping to match the level of public investment to the government’s and the economy’s absorptive capacity; (iv) promotion of good governance of the oil funds and within the government. Rent seeking and corruption are far less likely if the “expenditure smoothing” rules are invoked.

The performance record of stabilization and saving funds performance record is mixed, with some successes such as Kuwait and Alaska, and many failures, such as Ecuador. However, if well designed and professionally managed, they can be a beneficial tool for fiscal discipline
and long-term development of the country (see Appendix IV). Fiscal discipline in abiding by the rules of the fund, complete transparency in its revenue management, and maintaining a single national budget are necessary conditions for the fund to succeed.

**Recommended Actions for the Petroleum Sector**

176. In the first half of 2004, the National Petroleum Committee (NPC) was created to oversee the strategic development and policy issues related to the sector. The Committee includes representation from the Presidency of the Republic, the government, the National Assembly, the private sector and the NGOs. Simultaneously, the National Petroleum Agency was created to provide technical, legal and economic analysis to the government and the National Petroleum Committee. The Petroleum Unit was absorbed into the National Petroleum Agency. The government also started developing a sectoral law to: (i) frame the legal rights and benefits of the government and potential investors; (ii) provide for negotiation framework in the JDZ and EEZ; and (iii) create a fund for the future to manage the petroleum revenues with transparency and governance. The government still needs to implement fully arrangements for sector oversight and the revenue management law. From a public management perspective and given the country’s lack of capacity, the government still needs to take a number of urgent actions to prepare for the future revenue influx:

177. An economic analysis and alternative projections of the petroleum revenue influx and its potential impact on the economy needs to be done to inform the government about budgetary and policy choices. This analysis would entail an assessment of the economic implications of existing contractual and fiscal arrangements for DRSTP, and of proposed arrangements for the EEZ.

178. Develop a petroleum sector strategy. In the short-to-medium term, extensive and multi-faceted capacity building in the Petroleum Authority, other fiscal agencies within the government and the assembly is needed, covering legal, economic, technical and management policies. One way would be to twin nationals with foreign experts. In the short term, the more acute needs are concentrated in the legal and technical fields.

**C. Reinforcing Institutional Capacity Building And Governance**

179. In São Tomé and Príncipe, governance issues are multidimensional and interrelated, and directly affect growth by hampering the ability of economic agents to function within the clear policy guidelines of the formal private sector.

1. **Low Administrative Capital**

180. This issue can be framed in terms of two broad concerns. Low technical administrative capital does not support the proper formulation, implementation, and follow-up of policies. There is a clear need for targeted training and capacity building, particularly given the ongoing reform of the administrative structure and the emergent demands of the coming petroleum era. A
recent analysis of the directorate of taxes exemplifies the case in point. The tax directorate does not have the proper technical and professional capacity to assess taxes. Its employees acquired their expertise through on-the-job training, and therefore lack the essential problem solving skills gained through formal training. The directorate lacks definitive information regarding the total number of firms (or fiscal entities) to tax and lacks clear tax appraisal of the country's larger firms. The predominant informal sector, poorly identified and appraised, can escape registration and taxation altogether.

181. As highlighted in the literature on civil service reform, the lack of technical skills is only one aspect of the institutional capacity shortfall. In São Tomé and Príncipe, the low and highly compressed remuneration packages of the public sector and the sector's outdated professional categorizations harm the efficiency of public administration, encouraging absenteeism and reducing the incentive to work. In 2002 the minimum monthly salary was approximately 170,000 dobras (approximately US$18), and the maximum for a professional was only 300,000 dobras (some US$33)—less than double the minimum. Many of those who hold public positions supplement their income with outside activities.

182. The World Bank has been assisting in public sector reform designed to increase efficiency, improve incentives, and raise technical capacity. In January 2002, the separation and remuneration of 306 employees was finalized as part of the civil service reform. Work is also ongoing in restructuring and redefining civil sector employment categories and salary scales. Since 1999 the government has increased the wages of civil servants in the court system, Finance Ministry, Customs, Education Ministry, and the criminal investigation police to match wages in the private sector. Recent pay increases include two one-off payments in 2000–01, and in 2002 public employees received an average 20 percent increase and a 13th month Christmas bonus to appease the vocal civil service unions. Another 14 percent increase was planned for 2003, mostly directed to health and education sector employees. The 2004 budget included a 34 percent increase. A wage decompression and salary increase, including a minimum wage increase, are to be discussed and implemented at a later stage. Such increases may need careful reflection given the budgetary commitments under the macroeconomic stabilization program: despite an understanding with the IMF that it would control the wage bill, the country's payments to its public employees rose from 7.8 percent of GDP in 2000 to an estimated 9.6 percent of GDP in 2001 and 9.9 percent in 2003. One alternative approach could be to introduce performance-based bonuses applied to a base salary. Such bonuses could provide incentives for employees and thus lead to efficiency gains, while at the same time alleviating the budgetary pressure of large, across-the-board wage increases.

183. Training and capacity building is undertaken as and when individual units within the administration identify their needs. This approach leads to an ad hoc and disconnected training approach that is supported by different development partners, including the World Bank. The

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86 The remuneration and separation took place in January 2002. This was undertaken under the IMF program and financed by a European Union Structural Program, which was significantly delayed. The remuneration includes vocational training.
government should consider a comprehensive review of the needs of the administration, at least at the ministerial level, and should develop a strategic and coherent approach to which donors can commit themselves for the medium term.

184. Experience in many countries with a high level of aid dependence shows that the propagation of standalone (island) development projects run by bilateral and multilateral donors, in which national employees earn more than their public sector counterparts, discourages qualified individuals from working in the public sector. This has prompted calls to house projects within focus units of related ministries, to avoid the civil servant “brain-drain” and to provide a sense of ownership, without which project results may become unsustainable once donor money runs out. If the government were to adopt such an approach, it would have to ensure: (i) transparent management of these projects (i.e., the periodic release of information on progress, expenditure, and the granting of contracts); and (ii) the full participation of civil society and the private sector.

2. The Judicial and Administrative System

185. The judicial and regulatory system that should confer administrative and institutional validity on the government’s rule of law faces a number of critical issues. The regulatory framework is embryonic and the legal framework - commercial, penal, and civil codes - needs updating. Some of the codes (including the penal code, written in 1869) date back to the 19th century; updated with addenda, they depend for current relevance on the interpretation of the courts. The implementation of the rule of law governing economic interactions is very weak. For instance, the tax directorate lacks administrative credibility and holds no authority to implement or enforce tax laws that would help bring tax evaders to justice. There is no existing law to force taxpayers to pay; tax agents cannot recover taxes due by taxpayers at their business establishments and their bank assets cannot be frozen. In addition, their business establishments cannot be closed, nor is there any application in the law that allows for property seizure.\(^87\)

186. The judicial system additionally faces institutional and governance issues. The expediency and quality of judicial services are jeopardized by: (i) the lack of qualified, well-trained professionals; (ii) influence peddling, and (iii) inappropriate use of information and monetary gains.\(^88\) The resolution of tax cases via the court system can take as long as four years, according to one estimate. Even in a successful case, there is no existing legal instrument to implement the judgment. Despite the appointment of a judiciary system inspector in 2001, the judiciary inspection is not operational.

187. The PRSP acknowledges these inadequacies and the fact that the pursuit of good governance can make a significant impact on poverty reduction. It gives priority to consolidating the rule of law, including reform of the legal and judicial system through modernization of laws and capacity building. The government has recently launched a reform program to strengthen the rule of law and the legitimacy of its public institutions. It is liberalizing telecommunications and has adopted a legal and regulatory framework to this end. It

\(^87\) Christophe Malmond, October 2001, “Mission Fiscale: São Tomé.”

\(^88\) PRSP, December 2002.
also has established a regulatory unit to oversee the negotiations, liberalization process, and activities in telecommunications. The regulatory law and unit furthermore will in future encompass all utilities. The Ministry of Justice is developing a reform plan that includes legal and structural reforms and capacity building. In the next three years, the legal priorities are to update the labor, family, penal, and civil laws, administrative codes, and laws for the protection of minors. The plans to reform judicial institutions and to build capacity are still being developed, and a petroleum revenue law is scheduled for promulgation by early 2005.

188. Efforts are also underway to improve governance. In January 2002, following a series of financial scandals, President Menezes once again reiterated his and the Government’s dedication to increase transparency in public affairs. This includes the pursuit of former officials implicated in the issuance of fraudulent bonds; minting of coins by Central Bank employees; the concession of unlawful ship registrations; and irregularities in a housing construction contract. The government additionally commissioned a legal review of the oil contracts signed by the country to establish a clear understanding of their advantages and disadvantages (Annex IV, Table 1). It has since renegotiated with its four partners on the terms of the contracts. In 2003 the JDZ held a transparent bidding process for the jointly held petroleum blocks. The office of Accounting Tribunals also has been created and has been operational since July 2003, and the Central Bank and ENCO accounts are audited yearly and are publicly available online.

**Recommended Actions**

189. In the short term, each ministry (especially the ministries of finance, petroleum and infrastructure, health and education, and justice) should analyze their strategic capacity building needs in view of the country’s development needs and coming petroleum era. An action program can then be derived from this and implemented in the medium term at ministerial levels.

190. Finalizing the analysis of employment categories and salary scales of the civil service will permit policy conclusions to be drawn and a program of reform to be developed in line with the new vision of the State, as foreseen in the PRSP.

191. Initiating comprehensive judicial reform will necessitate the immediate development of a reform strategy and program of action, including a training program for the judges and judicial workers. In the medium term, comprehensive reform will be needed to modernize the legal framework in terms of the legal texts as well as the efficacy and fairness of the implementation structure, to provide continued training for judicial workers, and to strengthen the nascent judicial inspection process.

192. The government may also wish to promulgate the establishment of the regulatory framework for all utilities, identify its realm of authority and provide training for the regulators.

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89 The Economist Intelligence Unit, Country Report, April 2002.
D. Related Development Issues

193. The three key development priorities have been discussed above. There are, however, additional, related measures that should be taken to reinforce the actions and policies laid out in pursuit of these priorities.

1. Continued Reform at the MoPF

194. To help improve public sector management, reform within the Finance Ministry should be continued. The directorate has branched off into three sub-directorates (tax, budget, and treasury) to rationalize its work and to improve personnel allocation. While the role and responsibilities of the tax sub-directorate is clear, those of the budget and treasury are still being defined. The reform will also need to address the disjointed and weak administrative structure of the public management, as this constrains information sharing, adds to the regulatory burden, and reduces efficiency and transparency. For instance, taxes can only be paid at the Central Bank, where one person keeps the records manually and then physically transfers them to the finance directorate, where they are entered a second time into its ledgers. This practice has led to an estimated entry backlog of at least two months and is prone to human error. An integrated computerized information system within the MoFP (tax, treasury, budget, and the statistical bureau) and the Central Bank would permit real time assessment of revenues and expenditures and more accurate projection of the budget execution during the fiscal year.

195. The statistical bureau (INE) also lacks the technical capacity to address macroeconomic and microeconomic statistical needs: the bureau’s latest national accounts, for example, are just being updated to 2002 with the help of the international community. INE also has recently developed a strategic development plan and has started to remedy major data shortages and training needs, focusing on three thematic priorities: national accounts, poverty analysis, and benchmarking for the PRSP process.

2. Donors’ Coordination & PIP (public investment program)

196. Improved donor coordination regarding the PIP is highly desirable. The coordination of the government with the donor community is essential to ensure the compatibility of donor goals and financial cycles with the country’s strategic objectives, and to ensure the fiscal sustainability of donor projects.

197. As discussed in Chapter 2, donor coordination and PIP execution are weak. To address this issue, the government is moving toward a medium-term economic framework with more coherent, predictable budgetary and planning processes. This should improve the effectiveness of real expenditure, including PIP, as it can be planned over a longer period. The PIP is to be based on an improved, donor-coordinated, three-year commitment cycle in step with the macroeconomic framework to smooth out funding issues. It is also very important to ensure that the PIP programming and execution match the PRSP priority goals and actions, as implemented through the budgetary process. Harmonizing the procurement procedures of the government would further enhance the coordination effort. On the donors’ side, three measures would contribute to better monitoring and coordination of funds. First, all donors should be encouraged to report grant (cash and in-kind) and loan information on a more systematic basis to authorities,
especially the MoFP for budgetary purposes. Second, donor specialization in specific areas permits complimentary work among donors and a fuller coverage of the country’s investment needs. For instance, the EU has announced that its four-year cycle of funding, starting in 2003, will be dedicated to road building and repair (€9.4 million). Third, donors should harmonize their grant and loan procedures and requirements to simplify the government coordination tasks. A recent multilateral effort involving the World Bank promotes this harmonization effort.

3. **Weak Public-Private Partnership**

198. The public-private partnership needs to be strengthened, especially given that the development strategy gives the private sector the central role. Most NGOs and community-driven organizations are weak, and the level of communication and engagement between the public sector and private groups is low. This is partially due to a lack of means to inform and engage the population; the radio is the only relatively universal presence.

199. The dialogue between the government and the two private sector associations (the Chamber of Commerce and the **Associação dos Comerciantes e Industriais de São Tomé e Príncipe** is limited, with no focus on economic policies or on improved competitiveness. The nature of the dialogue, where it exists, is instead focused on short-term issues such as wages and is undertaken through the Chamber of Commerce, which also plays the role of employers’ association. The **Associação dos Comerciantes e Industriais de São Tomé e Príncipe** is smaller, and has a more limited role.

200. This situation is changing, as the government undertook extensive consultation in all six districts of São Tomé and on Príncipe when developing the PRSP. The PRSP also points to a need for better communication and information networks to help the poor improve their quality of life. The government could advance the public-private dialogue by introducing routine consulting with the private sector, communities, and NGOs on policy issues, and particularly on medium-term policy formulation and reform proposals (such as PSD development and judiciary reform) and the implementation processes of the PRSP.
5. MEDIUM-TERM ECONOMIC PROSPECTS

201. São Tomé and Príncipe’s recent reforms and stabilization program have led to the resumption of economic growth from 1 percent in 1997 to 4.1 percent in 2002. However, the recovery and growth are still fragile and the government should seize the opportunity to move ahead with reforms to accelerate growth, diversify the economy, and reduce poverty. The PRSP lays out the government’s goal for growth: to increase the rate of GDP growth to 5 percent in 2003 and beyond.

202. For the medium term, two scenarios are envisaged for illustrating the path to growth, income creation, and poverty reduction. Fiscal and monetary discipline are supposed to be in line with the PRGF (2003-2006). External macroeconomic conditions are expected to be stable, with no sharp increases in petroleum prices—the country’s main import, or sharp fall in cocoa prices, its main export. The government will freeze a majority of the expected bonus signatures in a savings fund (conservatively estimated at US$60 millions) so that “Dutch Disease” is averted. The optimistic higher growth scenario assumes the full implementation of reforms (regulatory, structural, infra-structural and institutional) delineated by the PRSP. In both scenarios, the prospective oil revenues are not incorporated in the medium-term framework, as they are not expected to materialize before 2008.

203. In the baseline scenario, medium-term sectoral growth rates will equal those of 2001 (see Annex I, table I.10). Cocoa exports provide export earnings for the country and income to the agricultural sector. Cocoa export volumes are not expected to rise, because of low productivity, lack of credit, and general extension support.

A. Medium-Term Prospects (2003-2006)

204. The baseline scenario (Table 5.1). GDP growth will continue its gradual pick-up to reach 5 percent by 2003 and 6 percent by 2006, fulfilling the PRSP growth objectives. Growth will still depend on fledgling non-traditional agricultural products, construction, and the performance of services (tourism and travel). The base scenario captures the current slow pace of reform implementation and a slow consolidation of reform gains and growth prospects. The economic recovery and growth will continue to be fragile as the economy is not diversified enough and remains highly vulnerable to external shocks.

205. In the absence of major external shocks and with sound macroeconomic policies in line with the PRGF, especially budgetary discipline and central bank restraint on credit issuance to the government, we expect inflation (GDP deflator) to drift down from 10.8 percent in 2002 to 4 percent by 2006.

206. Total and current expenditures will average 68 percent and 22 percent of GDP, respectively, reflecting the budgetary discipline of the government. While public investment will rise, the private sector share is expected to increase very rapidly, mostly driven by investments linked with the development of petroleum resources. The government’s capital expenditure is expected to be more in line with external financial support. At the same time, ongoing tax and fiscal reforms would be expected to lead to tax revenues of 21-22 percent of GDP. As a consequence, the primary and overall balances would remain in deficit over the period.
207. The country's debt remains unsustainable over the period. A December 2002 debt sustainability analysis reaches a similar conclusion. By 2006, the ratio of the net present value of total debt/export is 58 percent and the ratio of the net present value of total debt/government revenues is 563 percent. The ratios are largely unsustainable without further resources, in the form of "topping-off" in the HIPC process, further bilateral or multilateral debt relief assistance after the HIPC completion point, or in the arrival of petroleum revenues, and subsequent increased growth starting in 2010 to 2012 (not modeled here).

208. An optimistic scenario would entail a robust macro-economic discipline both in fiscal and monetary domains. Public sector reforms (privatizations, fiscal/tax administration reforms, promulgation of the new tax and investment code, and continued civil service reform) and improvements in the governance structure are expected to pick up pace in line with the policy suggestions in Chapters 3 and 4 (above). This accelerated and enhanced reform effort will lead to early efficiency and productivity gains in the public and private sectors. This favorable environment will in turn lead to a larger positive impact on employment and income creation, reducing poverty.

209. The effective PRSP implementation of sectoral strategies would lead to higher aggregate growth due to higher sectoral growth rates than those of 2001 (see Annex I, table I.10). Industrial growth relies on the ongoing construction boom, and services growth is driven by tourism/transport. A vitalized tourism is considered one of the main engines of medium-term growth in the PRSP. Within agriculture, the small but fast-growing food and non-traditional production sub-sectors will provide the main impetus for growth. A number of products have already performed well. For instance, banana, breadfruit, and taro grew by 25 percent, 12.7 percent, and 23 percent respectively over the 1994 to 2000 period. In the medium term, and given the PRSP plan to improve cocoa quality/price ratio and volumes, a sustained improvement in the export volumes can also be envisioned. It is anticipated that this enhanced growth will be associated with an increased employment, especially in the agricultural sector. With higher output growth in traditional and non-traditional exports, the total volume of exports would increase in the medium term. Higher GDP growth would also imply higher levels of imports. The current account balance will remain in deficit and the country will continue to depend on external assistance and concessional credit to finance its external account deficits.

210. The PRSP scenario implies higher levels of investment from two sources: public investment related to infrastructure expansion (in roads, education and health sectors in particular) and other private investment to support higher growth in exports and in anticipation of the petroleum era. Investment efficiency is also expected to increase, again due to the implementation of the PRSP-related structural and institutional reforms. Higher direct foreign investments would also materialize with successful implementation of the PRSP, which is likely to create an atmosphere conducive to attract foreign ventures.

211. PRSP-related expenditures, especially in infrastructure, education and health are likely to push up the level of total government expenditure. While accelerated tax and fiscal reforms would increase tax base and collection efficiency, it is likely that the budget will still run a deficit. The substantial foreign support would be necessary during this period to fill the resource gap necessary to deploy the PRSP investment program rapidly. The increased capital inflow associated with external assistance and the inflow of foreign direct investment may lead to some appreciation of the currency.
Table 5.1: São Tomé and Príncipe: Medium Term Prospects

<table>
<thead>
<tr>
<th>National income and prices</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP at constant prices</td>
<td>4.0</td>
<td>4.1</td>
<td>5.0</td>
<td>5.0</td>
<td>5.0</td>
<td>6.0</td>
</tr>
<tr>
<td>Gross domestic product</td>
<td>422.0</td>
<td>486.8</td>
<td>549.9</td>
<td>632.1</td>
<td>706.3</td>
<td>779.0</td>
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<tr>
<td>GDP deflator (percentage change)</td>
<td>9.8</td>
<td>10.8</td>
<td>7.4</td>
<td>9.7</td>
<td>6.4</td>
<td>4.0</td>
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<table>
<thead>
<tr>
<th>Government budget</th>
<th>(In percent of non-oil GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total non-oil revenue and grants</td>
<td>63.0</td>
</tr>
<tr>
<td>Of which: grants</td>
<td>41.0</td>
</tr>
<tr>
<td>tax revenue</td>
<td>18.6</td>
</tr>
<tr>
<td>interest earnings from oil fund</td>
<td>-</td>
</tr>
<tr>
<td>Total expenditure and net lending</td>
<td>77.8</td>
</tr>
<tr>
<td>Of which: noninterest current expenditure</td>
<td>21.8</td>
</tr>
<tr>
<td>personal costs</td>
<td>9.6</td>
</tr>
<tr>
<td>Primary non-oil balance (commitment basis; incl. HIPC spending</td>
<td>-5.9</td>
</tr>
<tr>
<td>Overall non-oil balance (commitment basis)</td>
<td>-14.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>National accounts</th>
<th>(in percent of GDP)</th>
</tr>
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<td>Consumption</td>
<td>123.4</td>
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<tr>
<td>Gross investment</td>
<td>29.8</td>
</tr>
<tr>
<td>Public investment</td>
<td>19.2</td>
</tr>
<tr>
<td>Private investment</td>
<td>10.6</td>
</tr>
<tr>
<td>Of which: non-oil sector</td>
<td>10.6</td>
</tr>
<tr>
<td>Gross domestic savings (in percent of non-oil GDP)</td>
<td>-23.4</td>
</tr>
<tr>
<td>Public savings (in percent of non-oil GDP)</td>
<td>-25.6</td>
</tr>
<tr>
<td>Private savings (in percent of non-oil GDP)</td>
<td>2.2</td>
</tr>
<tr>
<td>Gross national savings (in percent of non-oil GDP)</td>
<td>6.9</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>External Sector</th>
<th>(in percent of non-oil GDP, unless otherwise specified)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current account balance (excluding official transfers)</td>
<td>-60.4</td>
</tr>
<tr>
<td>Current account balance (including official transfers)</td>
<td>-23.0</td>
</tr>
<tr>
<td>Non-oil current account balance (excl. official transfers)</td>
<td>-60.4</td>
</tr>
<tr>
<td>Non-oil current account balance (incl. official transfers)</td>
<td>-23.0</td>
</tr>
<tr>
<td>Export earnings (in millions of U.S. dollars)</td>
<td>3.7</td>
</tr>
<tr>
<td>Of which cocoa</td>
<td>3.3</td>
</tr>
<tr>
<td>Overall balance (in millions of U.S. dollars)</td>
<td>-0.7</td>
</tr>
<tr>
<td>Exchange rate (in dobras per U.S. dollar; period average)</td>
<td>8,756</td>
</tr>
<tr>
<td>Exchange rate (in dobras per U.S. dollar; end of period)</td>
<td>8,949</td>
</tr>
<tr>
<td>Real effective exchange rate (depreciation -)</td>
<td>-6.5</td>
</tr>
<tr>
<td>Terms of trade (annual percentage change)</td>
<td>10.8</td>
</tr>
</tbody>
</table>

| Debt and debt services | |
|------------------------||
| Net present value of total external debt outstanding | 380.9 | 281.8 | 253.9 | 221.1 | 191.9 | 172.3 |
| Net present value of total debt 6% 7% 8% | 905.3 | 870.9 | 754.2 | 677.7 | 623.2 | 581.1 |
| Net present value of total debt 6% 7% 8% | 1,438.8 | 1,209.7 | 1,069.2 | 812.9 | 644.2 | 563.4 |
| External debt service before debt relief 8% 10% | 40.9 | 49.0 | 41.3 | 37.8 | 21.7 | 9.0 |
| External debt service paid 8% | 22.3 | 19.1 | ... | ... | ... | ... |

Sources: São Tomé and Príncipe authorities; and IMF staff estimates and projections.
1/ For 2002, reflects increases in cocoa export prices and nontraditional export volume.
2/ In percent of broad money at beginning of period.
3/ For 2003 includes the equivalent of 1 percent of GDP in revenue enhancing measures to be identified by the authorities.
4/ Excluding grants, interest earned and scheduled interest payments, and foreign-financed capital outlays.
5/ Excluding oil exports, c.i.f. imports of oil sector-related goods and services, and oil sector profit remittances.
6/ Including arrears to Italy on a loan that remains in dispute.
7/ Assumes that the completion point under the enhanced HIPC Initiative is reached in 2004.
8/ In percent of exports of goods and services.
9/ In percent of government revenue.
10/ For 2004, includes repayment of Nigerian oil bonus advance.
ANNEXES
## Table AI.1: São Tomé and Príncipe: Key Social Indicators

| Area (km²) | 1001 |
| Population (unit, 2000) | 137,000 |
| Growth Rate (latest decade) | 1.8 |
| Density (per km²) | 137 |

### Social Indicators

#### Population Characteristics
- Crude Birth Rate (per 1,000): 32,500 (1997)
- Crude Death Rate (per 1,000): 8,500 (1997)

#### Health
- Infant Mortality (per 1,000 live births): 71 (2000)

#### Income Distribution
- Highest Quintile: n/a
- Lowest Quintile: n/a

#### Distribution of Land Ownership
- % Owned by Top 10% Owners: n/a
- Owned by Smallest 10%: n/a

#### Access to Safe Water
- % of Urban Population: n/a
- % of Rural Population: 53.1 (1996)

#### Access to Safe Electricity
- % of Urban Population: n/a
- % of Rural Population: n/a

#### Nutrition
- Calorie Intake as % of Requirements: n/a
- Per Capital Protein Intake (g/day): n/a

#### Education
- Adult Literacy Rate (%): 83.4 (2000)
- Primary School Enrollment (net): 68.5 (2003)
- (% of relevant age group): n/a
### Table A1.2: São Tomé and Príncipe: Key Economic Indicators

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<tr>
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<tbody>
<tr>
<td><strong>Production</strong></td>
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<td></td>
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<td></td>
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<tr>
<td>Cocoa export volume (in '000s of metric tons)</td>
<td>3.4</td>
<td>3.2</td>
<td>2.8</td>
<td>3.8</td>
<td>3.3</td>
<td>3.8</td>
<td>3.0</td>
<td>3.1</td>
<td>3.5</td>
</tr>
<tr>
<td>Cocoa export unit value (in US$ per kilogram)</td>
<td>1.4</td>
<td>1.5</td>
<td>1.6</td>
<td>1.7</td>
<td>0.9</td>
<td>0.9</td>
<td>0.9</td>
<td>1.4</td>
<td>1.5</td>
</tr>
<tr>
<td>GDP growth</td>
<td>2.0</td>
<td>1.5</td>
<td>1.0</td>
<td>2.5</td>
<td>2.5</td>
<td>3.0</td>
<td>4.0</td>
<td>4.1</td>
<td>4.5</td>
</tr>
<tr>
<td>Consumer prices (percentage change; average)</td>
<td>37.2</td>
<td>37.5</td>
<td>67.7</td>
<td>50.9</td>
<td>16.3</td>
<td>11.0</td>
<td>9.5</td>
<td>9.2</td>
<td>9.6</td>
</tr>
<tr>
<td><strong>Percentage of Poor</strong></td>
<td>46.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td>53.8</td>
</tr>
<tr>
<td>(Annual percentage change, unless otherwise specified)</td>
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<tr>
<td><strong>External Sector</strong></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Exports, f.o.b.</td>
<td>-13.4</td>
<td>-3.1</td>
<td>8.1</td>
<td>-11.2</td>
<td>-17.3</td>
<td>-18.7</td>
<td>-2.1</td>
<td>62.1</td>
<td>20.1</td>
</tr>
<tr>
<td>Imports, c.i.f.</td>
<td>-3.6</td>
<td>-16.4</td>
<td>-3.2</td>
<td>-12.3</td>
<td>30.3</td>
<td>1.4</td>
<td>-0.4</td>
<td>7.5</td>
<td>7.1</td>
</tr>
<tr>
<td>Exchange rate (in dobras per US$, period average)</td>
<td>1,420.0</td>
<td>2,203.0</td>
<td>4,552.5</td>
<td>6,927.4</td>
<td>7,093.0</td>
<td>7,909.0</td>
<td>8,842.0</td>
<td>9,088.0</td>
<td>9,348.0</td>
</tr>
<tr>
<td>Real effective exchange rate</td>
<td>-25.6</td>
<td>1.4</td>
<td>-25.0</td>
<td>13.1</td>
<td>12.8</td>
<td>16.7</td>
<td>-6.5</td>
<td>-5.2</td>
<td>-8.7</td>
</tr>
<tr>
<td>Terms of trade</td>
<td>-3.4</td>
<td>8.6</td>
<td>11.4</td>
<td>14.8</td>
<td>-50.0</td>
<td>-1.5</td>
<td>24.5</td>
<td>15.1</td>
<td>12.4</td>
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<tr>
<td>Money &amp; Credit (end of period)</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Net domestic assets</td>
<td>7.0</td>
<td>28.2</td>
<td>-131.7</td>
<td>17.7</td>
<td>-15.3</td>
<td>15.0</td>
<td>7.3</td>
<td>2.6</td>
<td>1.2</td>
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<td>Credit to government (net)</td>
<td>-5.8</td>
<td>59.1</td>
<td>-113.4</td>
<td>18.2</td>
<td>-17.8</td>
<td>9.7</td>
<td>15.4</td>
<td>-0.2</td>
<td>16.0</td>
</tr>
<tr>
<td>Credit to the economy</td>
<td>-0.4</td>
<td>-28.2</td>
<td>-3.8</td>
<td>14.9</td>
<td>7.5</td>
<td>19.3</td>
<td>-2.0</td>
<td>11.6</td>
<td>26.3</td>
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<td>Broad Money</td>
<td>47.4</td>
<td>82.2</td>
<td>94.5</td>
<td>24.5</td>
<td>-28.8</td>
<td>36.7</td>
<td>26.9</td>
<td>50.9</td>
<td></td>
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<tr>
<td>Central bank discount rate (in percent; end of period)</td>
<td>1.4</td>
<td>35.0</td>
<td>55.0</td>
<td>24.5</td>
<td>46.4</td>
<td>36.7</td>
<td>26.9</td>
<td>50.9</td>
<td></td>
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<tr>
<td>Public savings</td>
<td>-27.6</td>
<td>-14.3</td>
<td>-17.3</td>
<td>-7.7</td>
<td>-11.9</td>
<td>-28.0</td>
<td>-15.1</td>
<td>-14.7</td>
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<td>Private savings</td>
<td>7.4</td>
<td>0.5</td>
<td>0.9</td>
<td>0.7</td>
<td>2.6</td>
<td>8.0</td>
<td>4.9</td>
<td>2.8</td>
<td>6.8</td>
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<tr>
<td>Gross National Savings</td>
<td>18.8</td>
<td>25.0</td>
<td>45.5</td>
<td>14.7</td>
<td>13.8</td>
<td>23.0</td>
<td>10.5</td>
<td>10.7</td>
<td>12.6</td>
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<tr>
<td><strong>Gross Domestic Savings</strong></td>
<td>18.8</td>
<td>25.0</td>
<td>45.5</td>
<td>14.7</td>
<td>13.8</td>
<td>23.0</td>
<td>10.5</td>
<td>10.7</td>
<td>12.6</td>
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<tr>
<td><strong>Government Budget</strong></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Total revenue and grants</td>
<td>39.9</td>
<td>113.7</td>
<td>116.5</td>
<td>107</td>
<td>109.3</td>
<td>103.6</td>
<td>123.0</td>
<td>112.3</td>
<td>107.9</td>
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<tr>
<td>of which: Grants</td>
<td>39.3</td>
<td>56.2</td>
<td>49.1</td>
<td>35.8</td>
<td>40.0</td>
<td>44.0</td>
<td>35.8</td>
<td>32.8</td>
<td>30.1</td>
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<tr>
<td>Total Expenditure</td>
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<td>70.1</td>
<td>59.6</td>
<td>68.9</td>
<td>66.1</td>
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Data from government sources. WB databases and IMF.
### Table AI.3: Gross Domestic Product and Expenditure at Current Prices; 1996-2003 (percentage of GDP)

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</table>

**Memorandum Item**

| Share of Gross Domestic Investment Financed by Foreign Savings (%) | 100 | 100 | 100 | 95.1 | 97.7 | 83.3 | 77.9 | 63.4 |

*Source: World Bank LDB, IMF*

- General. Text Table I provides a summary view of major aspects of recent macroeconomic performance. It does not preclude the more detailed review (supported by additional tables) of economic developments.
- Gross Domestic Investment is at current market prices.
- Where national sources do not disaggregate stock changes into private and public, the total change in stocks should be included under the private sector line 2.1.2.
- To the extent that national sources permit, the public sector should be a consolidated account of the general government (central, state, provincial or regional, and local) and public sector enterprises. In any event, the public sector definition used.
Table AI.4: São Tomé: External Aid and FDI (Balance of payments) 1995-2003

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Table AI.5: São Tomé and Príncipe: External Aid (Public Investment Program) 1994-2003

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<td>2.9</td>
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</table>

In % of total

| Public investment project | 100  | 100  | 100  | 100  | 100  | 100  | 100  | 100  | 100  | 100  |
| External resource        | 96.6 | 94.4 | 93.0 | 97.3 | 77.1 | 95.1 | 97.7 | 83.3 | 77.9 | 63.4  |
| Internal resource        | 3.6  | 6.0  | 7.5  | 2.7  | 29.7 | 5.1  | 2.4  | 16.7 | 22.1 | 36.6  |
| of which HIPC funds      |      |      |      |      |      |      |      |      | 10.8 | 13.4  |

Sources: World Bank and São Tomé and Príncipe authorities
Table AI.6: Balance of Payments 1995-2003

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<td>-5.48</td>
<td>-4.42</td>
<td>-4.91</td>
<td>-4.86</td>
<td>-4.79</td>
<td>-3.00</td>
<td>-2.7</td>
<td>-2.8</td>
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<tr>
<td>Other Factor Payments (net)</td>
<td>0.00</td>
<td>0.25</td>
<td>-0.07</td>
<td>0.12</td>
<td>-0.09</td>
<td>-0.09</td>
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<tr>
<td>Net MLT Borrowing</td>
<td>20.00</td>
<td>17.62</td>
<td>10.47</td>
<td>13.74</td>
<td>15.70</td>
<td>13.70</td>
<td>7.1</td>
<td>1.0</td>
<td>5.8</td>
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<td>Disbursements</td>
<td>13.50</td>
<td>12.30</td>
<td>6.20</td>
<td>5.40</td>
<td>9.60</td>
<td>6.60</td>
<td>6.80</td>
<td>2.30</td>
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<tr>
<td>Amortization</td>
<td>-4.60</td>
<td>-2.92</td>
<td>-3.87</td>
<td>-4.14</td>
<td>-3.10</td>
<td>-3.30</td>
<td>-4.00</td>
<td>-6.50</td>
<td>-7.40</td>
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<tr>
<td>Direct Private Foreign Investment</td>
<td>1.90</td>
<td>2.40</td>
<td>0.40</td>
<td>4.20</td>
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<td>3.80</td>
<td>3.30</td>
<td>5.20</td>
<td>8.00</td>
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<tr>
<td><strong>Other Capital (net) and Capital n.e.i.</strong></td>
<td>0.17</td>
<td>-3.02</td>
<td>0.13</td>
<td>-3.47</td>
<td>0.19</td>
<td>-0.02</td>
<td>5.50</td>
<td>8.00</td>
<td>9.10</td>
</tr>
<tr>
<td>Overall balance</td>
<td>-7.40</td>
<td>-4.80</td>
<td>1.10</td>
<td>-6.30</td>
<td>-2.70</td>
<td>-2.50</td>
<td>0.50</td>
<td>-2.80</td>
<td>4.40</td>
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<tr>
<td>Increase in Reserves (-)</td>
<td>-0.40</td>
<td>0.10</td>
<td>-7.40</td>
<td>2.70</td>
<td>-1.20</td>
<td>-2.00</td>
<td>-2.60</td>
<td>-2.10</td>
<td>-7.90</td>
</tr>
<tr>
<td>Gross Reserves (end year)</td>
<td>5.10</td>
<td>5.00</td>
<td>12.40</td>
<td>9.70</td>
<td>10.90</td>
<td>12.90</td>
<td>12.71</td>
<td>15.29</td>
<td>19.67</td>
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</table>
Table AI.7: Fiscal Indicators (in percent of GDP) 1994-2003

<table>
<thead>
<tr>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>Total revenue and grant</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax revenue</td>
<td>10.0</td>
<td>9.8</td>
<td>9.0</td>
<td>10.6</td>
<td>13.0</td>
<td>16.2</td>
<td>16.1</td>
<td>18.3</td>
<td>19.5</td>
<td>20.5</td>
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<tr>
<td><strong>Expenditure and net lending</strong></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Primary current expenditure</td>
<td>31.1</td>
<td>24.0</td>
<td>27.1</td>
<td>27.8</td>
<td>28.5</td>
<td>15.8</td>
<td>17.6</td>
<td>23.0</td>
<td>26.9</td>
<td>28.2</td>
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<tr>
<td>Personnel costs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital expenditure and net lending</td>
<td>42.7</td>
<td>53.5</td>
<td>42.1</td>
<td>42.2</td>
<td>31.1</td>
<td>42.3</td>
<td>42</td>
<td>45.6</td>
<td>29.4</td>
<td>27.6</td>
</tr>
<tr>
<td><strong>Primary overall balance, excluding grants (1)</strong></td>
<td>-9.9</td>
<td>0</td>
<td>-4.7</td>
<td>-2.2</td>
<td>0.7</td>
<td>1.3</td>
<td>2.1</td>
<td>-12.9</td>
<td>-4.3</td>
<td>-11.8</td>
</tr>
<tr>
<td><strong>Overall balance (commitment basis)</strong></td>
<td>-43</td>
<td>-37.4</td>
<td>-32.2</td>
<td>-26.7</td>
<td>-30.5</td>
<td>-25.9</td>
<td>-16.5</td>
<td>-20.0</td>
<td>-17.8</td>
<td>-17.2</td>
</tr>
</tbody>
</table>

1) Primary overall balance, excluding grants and foreign financed capital expenditures, including HIPC related spending
Table AI.8: Money, Credit and Prices (millions of dobras) 1997-2003

<table>
<thead>
<tr>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>Money Supply</strong></td>
<td></td>
<td></td>
<td></td>
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<td></td>
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</tr>
<tr>
<td>Money Supply</td>
<td>72050</td>
<td>89714</td>
<td>67200</td>
<td>112300</td>
<td>153500</td>
<td>194800</td>
<td>294000</td>
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<tr>
<td>Bank Credit to Public Sector, net</td>
<td>-33100</td>
<td>-20000</td>
<td>-36000</td>
<td>-27500</td>
<td>-10200</td>
<td>-10500</td>
<td>-25700</td>
</tr>
<tr>
<td>Bank Credit to Private Sector</td>
<td>7397.4</td>
<td>18109.1</td>
<td>24800</td>
<td>26000</td>
<td>23800</td>
<td>25100</td>
<td>41600</td>
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<tr>
<td>Money as % of GDP</td>
<td>36.0%</td>
<td>31.9%</td>
<td>26.1%</td>
<td>30.3%</td>
<td>36.4%</td>
<td>40.0%</td>
<td>52.8</td>
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<tr>
<td>General Price Index (1994 =100)</td>
<td>316.6</td>
<td>477.6</td>
<td>555.6</td>
<td>616.7</td>
<td>675.3</td>
<td>737.4</td>
<td>808.2</td>
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<tr>
<td><strong>Annual</strong></td>
<td></td>
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<tr>
<td>General Price Index</td>
<td>67.7</td>
<td>50.9</td>
<td>16.3</td>
<td>11</td>
<td>9.5</td>
<td>9.2</td>
<td>9.6</td>
</tr>
<tr>
<td>Bank Credit to Public Sector</td>
<td>-131.7</td>
<td>17.7</td>
<td>-15.3</td>
<td>15.1</td>
<td>17.3</td>
<td>-0.2</td>
<td>16.0</td>
</tr>
<tr>
<td>Bank Credit to Private Sector</td>
<td>-3.8</td>
<td>14.9</td>
<td>7.5</td>
<td>1.4</td>
<td>-2.0</td>
<td>11.6</td>
<td>26.3</td>
</tr>
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### Table AI.9: External Debt (US$ Millions)

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<th></th>
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<tbody>
<tr>
<td>Medium and Long Term Debt (DOD)</td>
<td>226.8</td>
<td>234</td>
<td>235.5</td>
<td>239.8</td>
<td>255.2</td>
<td>283.4</td>
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<tr>
<td>Non-Guaranteed Private Debt</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Outstanding &amp; Disbursed</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>300.1</td>
</tr>
<tr>
<td>Debt service ratio, before debt relief</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>49.8</td>
<td>33.6</td>
</tr>
<tr>
<td>Debt service ratio after debt relief, incl. HIPC</td>
<td>49.8</td>
<td>33.6</td>
<td>40.9</td>
<td>49</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>NPV of Debt to GDP, after HIPC initiative</td>
<td>45.5</td>
<td>24.2</td>
<td>10.2</td>
<td>10.1</td>
<td></td>
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<tr>
<td><strong>Total Outstanding &amp; Disbursed</strong></td>
<td>404.3</td>
<td>306.3</td>
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### Table AI.10: Sectoral Growth

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<tbody>
<tr>
<td>Agriculture</td>
<td>4.1</td>
<td>3.3</td>
<td>2.6</td>
<td>2.7</td>
<td>3.1</td>
<td>3.2</td>
</tr>
<tr>
<td>Industry</td>
<td>0.9</td>
<td>1.8</td>
<td>3.4</td>
<td>4.2</td>
<td>4.2</td>
<td>4.2</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>0.5</td>
<td>1.6</td>
<td>2.2</td>
<td>2.7</td>
<td>3.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Services</td>
<td>1.2</td>
<td>1.2</td>
<td>3.1</td>
<td>4.8</td>
<td>6.4</td>
<td>6.3</td>
</tr>
</tbody>
</table>

ANNEX II: DEBT DATA

Figure AII 1: São Tomé and Príncipe:

Comparison of Net Present Value of Debt Before and After Enhanced HIPC Initiative Assistance
(in US$ millions, end-December, 1999 in NPV terms)

Sources: São Tomé and Príncipe's authorities; and staff estimates. From HIPC Decision Point Document, December 2001.

Table II.1 below also provides basic information on the projected rise in social expenditures for São Tomé and Príncipe up to 2005.

Table AII.1: Social Expenditures
(in US dollars millions)

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
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</thead>
<tbody>
<tr>
<td>Social Expenditure</td>
<td>8</td>
<td>8</td>
<td>9</td>
<td>10</td>
<td>11</td>
<td>13</td>
<td>12</td>
</tr>
<tr>
<td>Social Expenditure/Government Revenue (in percent)</td>
<td>88</td>
<td>79</td>
<td>83</td>
<td>83</td>
<td>85</td>
<td>93</td>
<td>78</td>
</tr>
<tr>
<td>Social Expenditure/GDP (in percent)</td>
<td>17</td>
<td>17</td>
<td>18</td>
<td>19</td>
<td>19</td>
<td>20</td>
<td>17</td>
</tr>
</tbody>
</table>

90 Data from “São Tomé and Príncipe: Enhanced HIPC Debt Initiative,” WB, 2000. Data refer to pro-poor expenditure comprising health, non-university education, basic sanitation, and certain rural development and urban development programs. The figures for 2000 largely reflect social expenditure before HIPC relief because the country reached its decision points in early 2001. Thus, the full impact of HIPC relief for them will not be felt until 2001 and thereafter. Data for 2003 and 2004 are contingent on adequate external financing.
ANNEX III: UTILITIES AND SANITATION ISSUES

1. Existing garbage collection and sewage treatment issues have been largely shaped by the demands of the colonial era, when serving the plantation economics and urban settlements was paramount. With the demise of the colonial plantations, the system fell into disrepair. Lack of work and amenities led to an exodus to the cities, especially the capital, straining an urban infrastructure that has not been able to keep up with population growth. This phenomenon has been aggravated by the very low level of public sector investment in this sector. Virtually all financing for these investments comes from externally assisted projects. The following sections review the current conditions of these infrastructural components and their potential impacts on economic development, growth and poverty alleviation.

2. The telecommunications company CST was created in 1989 with a minority shareholding of 49 percent by the government and a majority shareholding of 51 percent by CPRM. CST was given an exclusive 20-year concession for telecommunications in São Tomé. Major improvements were made in the last decade. The number of lines doubled, reaching 4,614 in 2000 (or a density of 3.6 per 100 inhabitants, which is higher than the African average). It continues to grow at 15 percent per year. New subterranean cables have been laid in the urban areas and radio-electric systems are being put in place for remote villages. Internet connection services have been initiated.

3. In December 2001, the government signed another agreement with CPRM, giving it exclusive rights for international telecommunications for four additional years and prolonging the lack of competition in the market. On the other hand, mobile phone services were introduced in the market and licensing clauses were introduced in the contract. The government is in the process of adopting a legislative and regulatory framework for the sector. Once that has taken place, a licensing process will take effect, allowing, theoretically at least, for multiple bids. However, it is expected that CST will buy a multi-service license that would span over a 20-year period.\textsuperscript{91}

4. While the new agreement allowed for the upward adjustment of domestic rates, and downward adjustment of international ones, serious shortcomings continue to limit the telecommunications service. The charge for international calls is still two to three times higher than in the developed world, ranging from US$1.20 per minute for calls to Lisbon to US$2.70 to all countries other than a few with tariffs in between. A further problem with international calls is that a connection is often unavailable, or there is heavy congestion on the lines.

5. These factors (lack of competition, high prices, difficult international connection, lack of functioning legal and regulatory framework) constitute a serious bottleneck for private business and the tourism sector. The new contract leaves no near-term solution to these problems. Nonetheless the government's institutional and strategic policy consists of the following:

\textsuperscript{91} Given the four-year exclusivity that has already been granted to CST, the pricing of the license will hardly be competitive.
a. establishment of a legal framework to promote investments in the sector and to define the roles of the government and the operators of the network and the services.

b. liberalization of the market in telecommunications.

c. adoption of statutes for CST that correspond to the new legal environment without jeopardizing acquisitions.

d. creation of a regulatory body to provide oversight for the sector and to maintain a balance among the different actors.

6. Electricity is produced and supplied by Empresa de Água e Electricidade (EMAE). The price per kilowatt-hour (kwh) in São Tomé is higher than in other countries in the region. The price differential is due to the mix of power source, age of the technology, and high production losses of 27.9% percent in 2002. Furthermore, it faces a small customer base and major levels of theft and loss, amounting to about 40 percent of unpaid bills. Reducing this loss is difficult as a result of the deficient judiciary system and the large number of delinquent consumers.

7. The EMAE management is implementing a comprehensive reform plan in the electric power sector to prepare it for eventual privatization. The reforms were designed to yield a substantially improved supply and increased tariffs. Tariffs were increased by 16 percent in early 2002 as part of the reforms but had to be partially rolled back in July 2002 due to social unrest. Since then, the tariff structure has been modified, reintroducing the “social rate” to accommodate the poorer customers, and readjusted once again in January 2003 due to petroleum price increases.

Table AIII.1: Electricity Price Structure, 2001-2003

<table>
<thead>
<tr>
<th>Structure</th>
<th>July 01</th>
<th>January 02</th>
<th>June 02</th>
<th>Jan 03</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st range=&lt;100 kwh</td>
<td>721.57</td>
<td>1150.78</td>
<td>721.57</td>
<td>975.50</td>
</tr>
<tr>
<td>2nd range&gt;kwh e=&lt;300kwh</td>
<td>1150.78</td>
<td>1671.96</td>
<td>1150.78</td>
<td>1280.78</td>
</tr>
<tr>
<td>3rd range &gt; 300Kwh</td>
<td>1671.96</td>
<td>----------</td>
<td>1671.96</td>
<td>1671.96</td>
</tr>
<tr>
<td>Commercial</td>
<td>1671.96</td>
<td>1671.96</td>
<td>1671.96</td>
<td>1671.96</td>
</tr>
<tr>
<td>Industrial</td>
<td>1671.96</td>
<td>1347.72</td>
<td>1347.72</td>
<td>1347.72</td>
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<td>Public Administration</td>
<td>1671.96</td>
<td>1671.96</td>
<td>1871.96</td>
<td>1971.96</td>
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<tr>
<td>State Enterprises</td>
<td>1671.96</td>
<td>1671.96</td>
<td>1671.96</td>
<td>1671.96</td>
</tr>
<tr>
<td>Private Ex-patriates</td>
<td>1671.96</td>
<td>1671.96</td>
<td>1671.96</td>
<td>1671.96</td>
</tr>
<tr>
<td>High Tension</td>
<td>1500.13</td>
<td>1347.72</td>
<td>1347.72</td>
<td>1347.72</td>
</tr>
</tbody>
</table>

8. Major cost saving measure have been introduced, involving a 54 percent reduction of the labor force (from 294 to 136 employees) and a reduction in the theft of fuel and of electricity losses in the network in 2001-2002. Internal procedures have been streamlined. The company’s
loss was cut from 2.8 billion Dobra in 2000 to 1.5 billion in 2001, and the company had a positive balance of 1.3 billion Dobras in 2002.  

9. While the reliability of electricity supply has improved, the occasional power cuts and the high tariffs still pose an impediment to the private sector and to tourism development. The unavailability or unreliability of electricity outside the capital affects rural development and the poor (at home as well as in their need for services that require refrigeration and lighting, such as medical care). The costly and old production process is in obvious need of new investments in new more efficient and environmentally friendly technology that is at the same time more cost efficient to run.

Recommendation:

(i) An in-depth financial and technical assessment of EMAE should be made to update policymakers on the status of the firm, and policies to strengthen both aspects should be sought.

(ii) The company needs to develop a strategic development plan outlining its medium and long term investment goals, taking into account the beginning of the petroleum era and its potential significance on electricity demand.

(iii) Investment decisions in production and distribution will need to take into account the use of cheaper fuel sources than the high priced diesel currently used as well as more efficient technology.

(iv) The improvements in collection methods (such as pre-paid energy cards) will assist the firm ensure steady inflow of revenues.

(v) In the process of privatization, the unbundling of water and electricity is likely to be considered, and a strategic investor should be sought for the electricity part of the company.

10. Until the expected petroleum reserves come on stream, São Tomé and Príncipe will continue to rely on imported hydrocarbon products. Imports are handled by ENCO which buys solely from its Angolan parent company Sonangol. EMAE consumes about half of the total diesel fuel imported by ENCO for its power generation plants. The respective product prices in 2002 were as follows:

<table>
<thead>
<tr>
<th>Product</th>
<th>CIF/liter (US$)</th>
<th>Retail price/liter (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gas</td>
<td>0.29</td>
<td>0.59</td>
</tr>
<tr>
<td>Diesel</td>
<td>0.26</td>
<td>0.77</td>
</tr>
<tr>
<td>Petroleum</td>
<td>0.27</td>
<td>0.36</td>
</tr>
<tr>
<td>Jet-1</td>
<td>0.27</td>
<td>0.32</td>
</tr>
</tbody>
</table>

Source: ENCO

92 EMAE, Orçamento e plano financeiro para o ano economico de 2002, December 2001
93 ENCO, Relatório e contas 2001, p. 9.
11. It appears that São Tomé and Principe has sought to maintain some level of attractiveness to airlines by maintaining a low tax on Jet-1. However, paying almost US$3.00 per gallon of diesel is high, and it affects primarily heavy vehicles and buses used by the private sector in its agricultural transport and tourism operations. ENCO has opted since 2001 to adjust hydrocarbon prices to changes in world petroleum prices.

**Recommendation:**

(i) The government may wish to reformulate its gas and diesel taxation policy, especially as the taxes and their disposition do not provide adequate resources for the Road Fund to maintain the roads.

(ii) ENCO may wish to diversify from its sole petroleum supplier to ensure its supply line in case of potential disruptions.

4. Water

12. Even though the country is water-rich, there are water shortages, and the quality is poor due to the lack of treatment. Only 19.6 percent of the population has access to “canalized” water, with the poorest families constituting 9.2 percent of the ones with access, and poor and non-poor families making up 13 percent and 25.5 percent respectively. There are currently about 15,000 domestic connections serving an estimated 75,000 people in Agua Grande and neighboring districts. Substantial tariff increases have recently been made, but the service has only marginally improved. The connection fee of 1.7 million Dobra is considered to be out of the reach of poorer households, a problem that an African Development Bank (AfDB) assisted water supply project is addressing through the provision of 1,500 social connections at no cost to households in poor neighborhoods.

13. The renovation and expansion of water systems has not kept up with the rising demand. While better-off households and commercial establishments can make their own arrangements to store water and treat it, at a cost, poor people suffer when the service is bad.

14. The Water Supply Department of the EMAE is responsible for 12 water systems covering about two-thirds of the population. The other one-third is the responsibility of the districts, which have no financial resources for any activities in this field. A master plan for water supply prepared in 1996 still serves as a guide for prioritizing donor-assisted investments. Many of the proposed schemes have already been implemented.

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95 EMAE, op. cit. About 36 percent of the water produced by ENAE is consumed by individual subscribers, 41 percent by the public administration, and 12 percent by commercial and industrial users. Tariffs have been increased several times over the years, at a faster rate than inflation. As of January 2001, the tariffs were: 2,260 Dobra per m³ below 10 m³ consumption and 3,010 above for individuals, and 3,010 for commercial and industrial users.
Recommendation:

(i) Institutional and Supervisory

a. The proposed separation of electricity and water activities should be studied with care.

(ii) Policy and Implementation

a. Further improvements in the systems, other than major rehabilitation and expansion that should be externally assisted, should come from efficiency gains rather than from further tariff increase in real terms.

b. An affordability study should be carried out to assess the impact of the recent tariff increases for water and electricity on the poor and to recommend measures to provide assistance to them, if necessary, for better coverage.

c. The stand posts and public washing areas that are provided free of charge are not a sustainable solution to serve the poor, since much water is wasted because of inadequate maintenance and lack of concern for cost savings.

d. The current level of water rates should be able to cover the total costs of the water supply, since because the terrain is favorable, there is very little pumping involved, which is usually the main cost factor of urban water supplies.

5. Sanitation:

15. Serious deficiencies exist in solid waste collection, the use of toilets, and drainage, affecting mainly the urban population, and disproportionately the urban poor. The poor tend to live under more crowded conditions, sometimes in low-lying areas subject to flooding, where solid waste removal is irregular, increasing the risk of infectious diseases, including diarrhea, cholera, typhoid, hepatitis, and, indirectly, malaria. The unsanitary environment also has constraining effects on tourism as it diminishes the value of the country’s attractions (polluted and garbage-strewn city beaches are examples).

16. An effort has been made over the last decade to increase the number of households with latrines. The December 2002 PRSP suggests that only 16 percent of families have a septic tank or are connected to a public sewage system; 69 percent of the population use the outdoors. An

Contradictory data exist on the exact coverage. A study carried out in 1995 estimated that the percentage of households with latrines grew from 19 percent nationwide in 1991 to 28 percent in 1995. The corresponding figures for Agua Grande, the district with the highest coverage, were 27 percent and 35 percent. Assuming that this growth rate of 11 percent per year has continued up to now, the present national coverage would be 52 percent. A latrine construction program is currently underway in rural areas with assistance from UNICEF.
ongoing ADB-assisted project is providing some relief for unsatisfactory solid waste conditions in the central district of Agua Grande.\footnote{98}

17. Institutionally, the district administration is responsible for markets, solid waste collection, drainage, and latrines.\footnote{99} However, they are not given sufficient budgetary support to finance all their recurrent expenditures (apart from salaries, which are paid directly by the treasury). They are not allocated any capital expenditures, except for those projects provided by various donors and implemented largely through national agencies. Furthermore, the diffusion of the roles and responsibilities among the districts, DRNE and the Ministry of Health is a serious impediment to achieving substantial improvements in this sector. Finally, monitoring and evaluation are almost non-existent, as exemplified by the absence of a hydrologic monitoring network, with only one functioning hydrologic station in the country.

**Recommendation:**

(i) **Institutional and Supervisory**

a. There is an urgent need to assign a national *institutional responsibility* for policy and coordination for the entire environmental sanitation sector and to provide it with a sound financial backing. DRNE is the most likely body to perform this role.

b. Certain responsibilities should be transferred to the districts to allow them greater autonomy for revenue collection. This move has the potential of improving local service delivery; it will require external support, with infrastructure rehabilitation and expansion managed by the districts.

c. The institutional reforms that were proposed in the 1996 master plan should be implemented. Furthermore, the almost non-existent monitoring and evaluation should be reactivated.

(ii) **Policy and Implementation**

a. Any further draining of wetlands should be based on better environmental impact studies and should be part of a land-use plan that includes designated wetlands in and near urban areas for conservation, with adequate protection against encroachment. A study on this subject is currently underway with assistance from ADB.

\footnote{98}{This assistance is done through the provision of equipment, skip pads, identification of a new landfill site, and institutional support for the sanitation brigade of Agua Grande, which is part of the Direction of the Natural Resources and Environment.}

\footnote{99}{There are seven districts in the country, Principe being one of them. Agua Grande, which includes the capital, is the largest district, with an estimated 53,000 people, or 37 percent of the total population. They are headed by a District Assembly (Camera) and a Chief Executive (President). The Assembly members and the Chief Executive are currently appointed, but the present government is committed to holding elections in the districts for the Assembly members as well as the Chief Executive before the end of the year.}
b. Further programs to encourage the construction and proper use of latrines are needed, particularly in poor urban areas, to reduce the transmission of infectious diseases.

c. Garbage collection and sewage treatment improvements are urgently needed to reduce health hazards, especially in the poorer, more crowded neighborhoods. Developing a long-term plan with one or two bilateral donors in this area could provide the investment and institutional capacity building needed for this undertaking.
ANNEX IV: PETROLEUM REVENUE MANAGEMENT

1. Petroleum resources can be a blessing or a curse, depending on the manner in which they are managed to affect the economy. This annex outlines the steps necessary to establish a legal and institutional framework for the petroleum sector so that São Tomé and Príncipe is prepared to avoid this curse. This note then provides an overview of the potential pitfalls of oil economies and suggests creation of a petroleum fund to assist the government in avoiding them.

Strategy and Medium-Term Policies

2. São Tomé and Príncipe lacks the basic legal, institutional and technical capacity to address the birth of a major sector. In 2002, a small Petroleum Unit was created and has tackled the initial process of organizing government response to international interest. Nonetheless, much more needs to be undertaken:

3. The government needs to elaborate a "vision" or strategy for the sector. This should come sooner rather than later as lack of clarity on the development of the sector, on the roles to be played by different governmental agencies or lack of coordination of sector activities are bound to dampen the interest of investors as well as donors.

4. An analysis of the potential petroleum resources in the Joint Development Zone shared with Nigeria (JDZ) and Exclusive Economic Zone (EEZ)- with an eye to providing an initial assessment of the revenues, will help the country frame the discussions on strategic choices and policies to adopt, such as a saving fund. This analysis would entail an assessment of the economic implications of existing contractual and fiscal arrangements for DRSTP.

5. In the first half of 2004, the National Petroleum Committee (NPC) was created to oversee the strategic development and policy issues related to the sector. The Committee includes representation from the Presidency of the Republic, the government, the National Assembly, the private sector and the NGOs. Simultaneously, the National Petroleum Agency was created to provide technical, legal and economic analysis to the government and the National Petroleum Committee. The Petroleum Unit was absorbed into the National Petroleum Agency. The government also started developing a sectoral law to: (i) frame the legal rights and benefits of the government and potential investors; (ii) provide for negotiation framework in the JDZ and EEZ; and (iii) create a fund for the future to manage the petroleum revenues with transparency and governance. The government still needs to implement fully arrangements for sector oversight and the revenue management law.

6. Human capacity building will have to be undertaken in legal, economic, technical, and management fields. One way is twinning of nationals with foreign experts. In the short term, the more acute needs are concentrated in the legal and technical fields. In the medium to long term, economic and management training would give nationals the tools to assess and implement policies on their own.
7. An action plan should be developed for the creation of the fund for the future to manage petroleum revenues to ensure maximum developmental impact and to minimize their potential disruption of the economy (see below).

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**Box IV.1: Status of Petroleum Agreements as of end 2002**

- **Environmental Remediation Holding Corporation (ERHC) agreement**
  A memorandum of Agreement (MOA) was reached with ERHC in May 2001. This was a settlement of international arbitration proceedings that had started in 1999 over an 1997-MOA with ERHC and Procura Financial Consultants (PFC). The 2001 agreement granted broad rights to ERCH for 25 years starting in October 1999. The company has no monetary or work obligations to the country, whatsoever. The rights ERCH still hold can substantially delay STP efforts to attract foreign investment in this sector.

- **Environmental Remediation Holding Corporation (ERHC) agreement**
  ERCH did relinquish the right to negotiate with major petroleum companies on behalf of the government, its shares in STPtol (the national petroleum company) and a minimum of the four best concessions in the DRSTP, exclusive economic zones. It has retained the right to 10 percent of its share of all profit oil received from operations in the JDZ with Nigeria, 5 percent of STP’s signature bonuses, 1.5 percent of oil and gas income from production of crude oil and/or natural gas in the JDZ, an option to acquire up to 15 percent paid working interest in up to two blocks of ERCH’s choice in the JDZ and two more in the EEZ, and the option for up to two blocks in the EEZ outside the JDZ.

- **Technical Assistance Agreement with Mobil Company, September 1998**
  Mobil is to perform a two-dimensional reconnaissance seismic program, defined solely by the company, the time (18 months) and financial terms of which are standard. In exchange, STP receives US$4 million total and a 5 percent contractor’s interest in production-sharing contracts (PSCs) in the event Mobil exercised its right of first refusal. Mobil also has the right to participate in PSCs covering up to 22 blocks in the STP territory. It pays a US$5 million signature bonus upon execution of the PSC and an additional bonus of US $1 million per block chosen by the company to be included in the PSC.

- **Seismic services agreement (SSA) with PGS exploration, February 2001**
  The government granted PGS the exclusive rights for seismic and geological data control for an unusually long period of at least 10 years. Furthermore, the government now needs to require all contractors to subscribe to SSA services to obtain this information without commensurate obligations for reasonable access charges. Finally, PGS has acquired the right to PSCs for up to three blocks within the area covered by the E&P option agreement. For all these rights, PGS pays the government US$2 million, an unusually low amount compared to the industry average.

- **Treaty with Nigeria, February 2001**
  The treaty establishes a joint development zone between the two countries, with a 50 percent share for Nigeria and a 40 percent share for STP. Nigeria has claimed a Special Regime Area that has very good hydrocarbon prospects, without clear and binding commitments to reimburse STP for this designation. Nigeria has agreed to provide assistance that would include certain development projects such as refinery and crude oil allocation, working interest in blocks, a port facility in STP, and coast guard equipment and training. One hundred forty scholarships for STP nationals have been agreed to in the ongoing negotiations.

A council of four ministers or equivalent rank will have responsibility for exploration and exploitation of the resources in the zone. A joint authority will have the power to enter into contract and to manage daily activities in the zone. It will be overseen by a six-member board. The authority is seated in Nigeria, and its government has fronted the funds for its launch.
8. The potential problems with mineral resources are highlighted by the experiences of other mineral rich countries:

9. The volatility of oil revenues often creates an unstable, stop-go, budgetary pattern and economic performance. These cyclical patterns will make the economy more prone to business cycles. A typical example is that of Yemen. In 1998, a large oil price drop caused a 30 percent fall in the terms of trade, a 15 percent decline in real gross domestic income, and a 45 percent decline in government export revenue, affecting the budget severely and delaying planned expenditures and investments. The government had to borrow 3 percent of GDP from the central bank, and the concomitant money supply expansion led to inflation.

10. Revenue windfalls are often mismanaged. One reason is that as government spending rises during a oil price boom, non-tradable goods prices rise. This slows or draws away resources from non-oil traded goods sectors (including agriculture). When the boom is over, it is extremely difficult to restore growth in the affected sectors (this is also called Dutch Disease).

11. The countries often lack sufficient absorptive capacity. Countries such as São Tomé and Príncipe with pressing infrastructure needs may be tempted to undertake investment in domestic physical assets as well as to promote the growth of the non-oil sectors with the oil windfalls, and avoid the Dutch Disease. There are very few successful examples of this type of expenditures, which tend to rise to unsustainable levels, and lead to poor-quality projects.

12. The concentration of the rents in the fiscal authority tends to weaken the incentives for budgetary restraint, leading to overexpansion of government. Without a transparent and accountable governance structure this concentration leads to rent seeking and corruption and, consequently, to the misallocation of resources.

13. The key to avoiding some of the economic difficulties discussed above is to "smooth" expenditure. The gains from adopting smoothing rules are in accepting and imposing budgetary discipline, and the assumption that a certain amount of annual revenue flow in perpetuity is desirable. Long-term benefits to expenditure smoothing by means of a stabilization or savings fund structure are threefold, as described below.

(a) The economy is insulated from the deleterious effects of the mineral resource boom-bust cycle by mitigating the "decline" of the non-mineral traded goods that are crucial to the development of the non-oil economy. The permanent

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100 "Yemen in the 1990s: From Unification to Economic Reform," K. Enders, et al. International Monetary Fund Occasional Papers, No. 208, 2002. Real gross domestic income = RGDP + terms of trade effect (p. 10). The Yemeni economy became highly dependent on oil, with the share of oil in GPD nearly doubling from 10.7 percent in 1992 to 20.2 in 1999. Oil accounted for 80 to 90 percent of total exports for the 1994-99 period. This dependence has increased the vulnerability of the economy to petroleum price changes as well.

101 One can think of the oil as "capital." The consumption stream (i.e., the benefits) derived from the oil can only be realized by its extraction and sale. When that happens the stock of "capital" is gradually depleted, and so over time it will generate less and less consumption. To ensure a smooth consumption stream, it is necessary to replace the depleted "capital" with physical or financial capital. This has been called replacing the assets below the ground with assets above the ground. This means calculating the maximum level of expenditure that can be sustained in perpetuity.
production and price shocks or new resource discoveries may necessitate adjustments to the permanent level of expenditure. However, these adjustments will tend to be more moderate if the "smoothing" strategy is maintained, thus providing a more predictable and favorable investment climate for the private sector.

(b) It helps match the level of public investment to the government’s and the economy’s absorptive capacity.

(c) Finally, it promotes good governance of the oil funds within the government. Although this is neither necessary nor sufficient, rent seeking and corruption are far less likely if the “expenditure-smoothing” rules are invoked. Government would remain more limited and investment would be built up gradually, reducing the benefits of rent seeking and corruption. However, independent efforts at maintaining fiscal transparency and accountability will be required.

14. The actual rules of expenditure smoothing can take different structures based on the development objectives of the country. They can espouse the form of constant expenditure in perpetuity in real per capita terms; constant nominal expenditure in perpetuity; discounting future spending, or a fixed dollar amount of expenditure based on the “permanent” income. Alternatively, smoothing rules could be based on an appropriate non-oil fiscal policy stance (the non-oil balance or non-oil government revenue and budget).

15. Smoothing expenditure is essentially undertaken through the creation of a stabilization or savings fund. A stabilization fund is designed to stabilize the impact of volatile revenues available to the budget, but it usually does not affect fiscal spending directly. In the process it can also support fiscal discipline and provide greater transparency in revenue spending. However, stabilization funds rarely succeed in stabilizing fiscal spending and are typically not an effective vehicle for dealing with resource depletability.

16. Finally, these funds may have a role where the output stream is a steady-state feature, with income depending mainly on price volatility. But volatility in São Tomé and Príncipe’s case has as much to do with volume as price at this point. This type of fund may not be as relevant to São Tomé and Príncipe’s current situation.

17. Savings funds create a store of wealth for the future generations and focus on the inter-temporal consumption smoothing, but their performance record is mixed. Successful examples include Norway, Kuwait, and the State of Alaska. For many other countries, such as Ecuador, such a fund did not bring the expected benefits (see box). If there is dollar inflation of X percent, then real income from the oil has gone down by X percent if the price of oil or proven reserves has not changed. If the relative price of oil changes, then, as noted, the estimate of “permanent” income would change commensurately. However, adoption of fixed-proportion rules have at times, led to contradictory situations where governments borrow to fulfill their accumulation obligations to the fund.

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5. Given the country's limited capacity, establishment of the fund requires an institutional framework to deal with the key objectives outlined below:

(a) The fund should fit consistently within the overall fiscal and medium-term budgetary framework of the country. Emergence of a dual budget system should be avoided. No fund targeting or independent spending authority should be allowed. Ideally, transfers to and from the fund should require parliamentary approval. Earmarking reduces the fiscal flexibility of the central government, locking in spending increases during oil windfalls and forcing drastic cuts in operating and discretionary expenditures during downswings.

(b) The fund should not be used as collateral to increase borrowing for capital investment or government expenditure. Specifically, in the absence of liquidity constraints, savings funds would not necessarily lead to higher savings, as the government can finance spending in other ways or use the funds as “collateral.” An effective savings fund is therefore one where the fiscal authority feels bound by the “rules.” As such, a fund can act as an institutional mechanism to reinforce fiscal prudence and enhance transparency.

Box IV.2: Problems with Earmarking Funds: The Case of Ecuador

In 1999, about 65 percent of total tax revenues (including all oil revenues) in Ecuador were earmarked for specific programs or for transfers to sub-national governments, despite a weak non-oil tax administration and the resulting volatility in revenues. The earmarking system illustrates the power of Ecuador's network of entrenched interests vis-a-vis the unstable central government: 14.5 percent of all oil revenues had been earmarked directly to the military since 1989; 67.6 percent were allocated to finance public wage bill and other programs, notably the rural roads program, a politically important source of patronage. The complexity and non-transparency of the earmarking process has produced unforeseen and irrational distributions of oil revenues, major beneficiaries of which have historically included the inefficient and overstaffed bureaucracy of PETROECUADOR, the military, and the civil services. In this case, in times of low petroleum prices, the country faces severe budgetary shocks, and the government faces the difficult task of trying to cut the entrenched benefits of special interest groups.

(c) The fund should be managed at arm's length by two or three independent and competing top-rated international fund managers. Each would have the objective of maximizing the yield of the invested funds subject to carefully chosen investment criteria, including prudential investment rules, published guidelines regarding desired risk-return combination, and the proportions to be

106 For a more complete discussion, see Brian Bell, "Trust Funds for Improved Governance and Economic Performance in Developing Countries." Paper presented at the AARES 45th Annual Conference, Adelaide Australia, Jan. 2001.
invested in different types of assets, etc. The performance of the managers could be monitored frequently and, following periodic reviews, the worst performer replaced.

(d) Ideally, the asset management strategy for the fund should reflect a consolidated portfolio of the government, with short-term asset operations conducted in a coordinated manner consistent with the debt management operations of the MoFP, the treasury’s management of government cash flow, and the financial assets already held as part of the government’s balance sheet.

(e) Clearly defined rules, purposes, and objectives for the fund are important to improve transparency and establish the legitimacy of fund operations. The legislature and the general public should be regularly notified of the principles governing the fund, its inflows and outflows, and the allocation of assets to assist in the transparency process. A detailed annual report, preferably involving audits by internationally established experts, can also serve to provide important information such as asset allocation, summary statistics on the performance of the portfolio, and a retrospective of activities of the fund during the year. The Norwegian State Petroleum Fund, the Alaska Permanent Fund, and the Tuvalu Trust Fund are best practice examples in this regard.

When fund managers are instructed to invest in particular sectors or business activities rather than aim for the highest possible return (in appropriate risk parameters), the savings fund becomes a slush fund.
The Government Petroleum Fund, established in 1990, has two main purposes:

(i) to act as a buffer to smooth fluctuations in oil revenues and mitigate exchange rate pressures to avoid Dutch Disease and preserve a diversified industrial structure; and

(ii) to save part of the current oil rents to help address future needs related to the aging population and the eventual decline in oil revenues.

At the end of 2001, the size of the fund was about 45 percent of GDP.

The fund is an integrated part of the budget. The income of the fund is the government net cash flow from petroleum activities plus the return on capital. Its expenditures are transfers to the government’s budget. Higher government spending or lower taxes from mainland activities result in smaller allocations to the fund. The annual allocation of oil revenues between the budget and the fund is flexible, depending on stabilization considerations.

Transparency and governance rules are adhered to:

(i) The government always consults the parliament before making substantial changes to the fund’s operational guidelines.

(ii) Transfers to and from the fund need parliamentary approval.

(iii) The government informs the parliament on the fund’s status three times a year.

(iv) Comprehensive information about the fund’s operations are available in quarterly and annual reports, and the auditor general has overriding responsibility for auditing its operations.

(v) To protect the integrity of the budget process, the fund’s assets must be invested abroad rather than become a supplementary source of financing public expenditures.

**ANNEX V: MATRIX OF PRIORITY POLICIES AND ACTIONS**

<table>
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<tr>
<th>Engendering Private Sector Development</th>
<th>Short Term</th>
<th>Medium Term</th>
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<tr>
<td>administrative systems:</td>
<td>2. Reform of business licensing and registry procedures.</td>
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<td></td>
<td>3. Adopt land legislation to clarify land tenure and use rights.</td>
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<td>2. Reduce government role in economy:</td>
<td>1. Review privatization process and develop new action plan.</td>
<td>1. Implement new privatization action plan.</td>
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<tr>
<td>3. Improve the fiscal environment:</td>
<td>1. Further review draft tax and investment codes.</td>
<td>1. Continue the on-going tax administration reform process.</td>
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<td></td>
<td>2. Promulgate new tax code, including new investment code.</td>
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<td>4. Address constrained credit to the</td>
<td>1. Adoption and promulgation of legal status for the credit</td>
<td>1. Strengthen supervisory capacity within the banking system.</td>
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<td>private sector:</td>
<td>institutions, the definition of homogeneous financial rules and</td>
<td>2. Pursue the establishment of new banks to increase competition in the market.</td>
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<td></td>
<td>integration of the micro-credit system into the national banking framework.</td>
<td>3. Training on management and supervision for management teams of the micro-credit entities.</td>
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<td>5. Improve transport and market</td>
<td>1. Develop an infrastructure strategy for 2004-2006 in concordance with</td>
<td>1. Capacity building in and provision of resources to national road agency SENAE, so that</td>
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<tr>
<td>infrastructures:</td>
<td>PRSP needs.</td>
<td>it becomes the sole authority in road maintenance.</td>
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<td></td>
<td>2. Develop and promulgate an open sky policy and address the privatization</td>
<td>2. Airport safety system, landing strip and reception area will require full modernization.</td>
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<td></td>
<td>of the Air São Tomé company.</td>
<td>3. Facilitation of acquisition of ice makers.</td>
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<td></td>
<td>3. A feasibility study and action plan for airport modernization.</td>
<td>4. Construction of cold storage chains at key locations (packing centers, central markets,</td>
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<td></td>
<td>4. A study on the costs of building a deep sea port.</td>
<td>export terminal cold rooms).</td>
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<td></td>
<td>5. Further reform of the port administration as described in Chapter 3.</td>
<td>5. Develop a deep sea port with private sector financing.</td>
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<tr>
<td>Enhancing Support To The Social Sector</td>
<td>Short Term</td>
<td>Medium Term</td>
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| 1. Health:                            | 1. PRSP health targets urgently need to be completed.  
                                          2. Review the HP and NHDP to prioritise goals and to match them with the final PRSP health targets and the millennium development health goals, as well as the budgetary and human resource constraints.  
                                          3. The NHDP should emphasize clearly the minimum health package (MHP). | 1. Need for a more developed policy for human resource management (training, professional development, and better salary structure). Special emphasis on strengthening the managerial capacity in the sector. |
| 2. Education:                         | 1. Ensure that the educational strategy fits with the PRSP educational goals and MDGs.  
                                          2. Implement the *carta escolar* (school mapping).  
                                          3. Provide plan of action based on educational strategy that includes program to equip students for employment in the technical and professional fields where labor demand exists. | 1. In-depth institutional reform needs to be mapped out and launched.  
                                          2. Extensive capacity building at the managerial (management, planning, and evaluation) based on education strategy.  
                                          3. Education for youth should provide training to match the demands of the market. |

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<tr>
<th>Improving Public Sector Management</th>
<th>Short Term</th>
<th>Medium Term</th>
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| 1. Public Sector Management:      | 1. Public Investment Program (PIP) should become fully coordinated with the budget nomenclature and PRSP goals and donors.  
                                          3. Budget execution: Adopt a double ledger accounting program, consolidate all fiscal data.  
                                          4. Budget execution: Implement integrated computerized system within the MoFP and with the Central Bank to improve transparency and expenditure tracking.  
                                          5. Budget Monitoring: Implement systematic *a priori* financial control for the budget.  
                                          2. Submit yearly budget execution report to the National Assembly. |
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<th>Improving Public Sector Management</th>
<th>Short Term</th>
<th>Medium Term</th>
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<tr>
<td>2. <strong>Petroleum:</strong></td>
<td>1. Economic analysis: alternative projections of the petroleum revenue and potential impact on the economy to inform budgetary and policy choices (including related to the use of a savings fund).</td>
<td>1. Capacity building in the Petroleum Authority, other fiscal agencies within the government, and the assembly. Training to cover: legal, economic, technical and management policies.</td>
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<td></td>
<td>2. Make the Fund for the future operational as quickly as possible.</td>
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<td></td>
<td>3. Institute the basic institutional structure for supervision and regulation of the sector;</td>
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<td>4. Training: legal and technical fields.</td>
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<td>5. Develop a Petroleum sector strategy to set the development path of the sector.</td>
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<tr>
<td>Strengthening Governance and Building Institutional Capacity</td>
<td>Short Term</td>
<td>Medium Term</td>
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<tr>
<td>1. Civil Service Reform:</td>
<td>1. Finalize the analysis of the restructuring and redefining of employment categories and salary scales and provide policy recommendations in view of the new role the State defined in the PRSP and the upcoming petroleum era.</td>
<td>1. Implement the policy conclusions from the civil service analysis.</td>
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<tr>
<td>2. Judicial and Regulatory Reforms:</td>
<td>1. Develop a comprehensive program of judicial reform. 2. Develop strategic training program for judges and judicial workers. 3. Expand the regulatory framework to all utilities (currently only including Telecoms), and identify its realm of authority.</td>
<td>1. Update all legal codes (commercial, penal, civil, etc.). 2. Training for judges and judicial workers. 3. Training for the utilities regulatory agency. 4. Training for the Accounting Tribunal.</td>
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<td>4. Transparency and Coordination:</td>
<td>1. Improve donor coordination (exchange of data, project and program coordination). 2. Formalize existing consultations with the private sector, communities and NGOs on national policy issues and implementation of the PRSP.</td>
<td>1. Improve donor coordination (investment programming and follow-up, coordination of grants and loan processing, specialization of donors in specific sectors etc.). 2. Routine consultative mechanism with the private sector, communities and NGOs on national policy issues, PRSP implementation, etc.</td>
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