

# **SÃO TOMÉ E PRÍNCIPE**

## ***DIAGNOSTIC TRADE INTEGRATION STUDY***

### **DRAFT CONCEPT PAPER**

#### **1. Introduction**

1. The Integrated Framework (IF) was established under the World Trade Organization (WTO) in October 1997, to facilitate the coordination of trade-related technical assistance to least developed countries (LDC), and to promote an integrated approach to assist these countries in enhancing their trade opportunities. The original IF entailed the preparation of a Needs Assessment for the eligible LDCs followed by a Roundtable or Consultative Group meeting to secure donor financing for the trade action plan. However, an independent review of the IF programme concluded that the IF only produced modest results and that a new approach was required. Emerging from this review, the IF Working Group recognised the need to ensure integration between the trade strategy and overall development strategies for the country, as well as closer coordination of the donor community, including the six IF partner institutions<sup>1</sup>, in the provision of technical assistance to LDCs. The new approach, piloted initially for Cambodia, Madagascar and Mauritania during July–October 2001 and currently underway in several other countries, introduced the Diagnostic Trade Integration Study (DTIS) as a vehicle to analyze constraints to LDC integration into the global economy, identify the trade-related technical assistance needs to enhance the country's prospects for increased integration into world trade, and to integrate trade issues into the country's national development strategies including its poverty reduction strategy.

2. São Tomé e Príncipe (STP) reached the Decision Point of the enhanced HIPC Initiative in early 2001. It is anticipated that Completion Point would be attained in late 2004. As indicated in the PRSP<sup>2</sup>, STP's poverty reduction strategy rests on five major axes:

- Promoting accelerated and equitable economic growth.
- Stimulating the creation and diversification of revenue-earning activities.
- Developing human capital and extending and deepening access to basic social services.
- Reform of public institutions, strengthening of capacity in the public sector, and promoting a policy of good governance.
- Adoption of mechanisms for monitoring, evaluating and updating the strategy.

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<sup>1</sup> These are the International Monetary Fund (IMF), the International Trade Center (ITC), the United Nations Conference on Trade and Development (UNCTAD), the United Nations Development Program (UNDP), the World Trade Organization (WTO) and the World Bank.

<sup>2</sup> The PRSP was formally adopted in a public forum in December, 2002.

A plan of action accompanies these strategic targets with global poverty alleviation objectives. The ambitious outcome targets include a reduction in the number of poor by one half by 2010 and to less than one third of the population by 2015.

3. Given that STP is a small, open, island economy heavily dependent on imports and external financial assistance, it is self-evident that trade must play a central role in the attainment of these objectives. The DTIS will therefore be closely linked to STP's poverty alleviation strategy as set out in the PRSP. It will indicate not only the opportunities for growth and diversification of exports, but also the macroeconomic and poverty alleviation impact of enhanced trade. To the extent that data permits, a simple model will be developed which will allow policy makers to measure the effect of increased trade and external shocks on the sectors where the poor derive their income and the key products they consume. The DTIS will include concrete policy recommendations and an action matrix which, once accepted by the government and other national stakeholders, would be incorporated into the PRSP. The IF exercise would thus seek to make a significant contribution to the formulation and implementation of a development strategy for STP during the coming years.

4. Despite major current constraints, the islands' geographical location endows them with a significant potential as a trading center. As some scholars have pointed out, at various historical moments, the islands of STP have assumed considerable importance in the global economic system.<sup>3</sup> Now, after decades of relative decline and stagnation, STP stands at the threshold of the oil era. The onset of regular oil production from offshore fields, anticipated in some eight years from now, is certainly the most significant economic event facing the country in the foreseeable future, with far-reaching social and political implications. In the following table, the projected oil production figures must be regarded as tentative at this stage, but there looks to be a strong possibility that the resources and revenues accruing to STP will be very large indeed relative to its size<sup>4</sup>.

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<sup>3</sup> In the sixteenth century, the islands were the world's greatest sugar producer, and in the nineteenth and early twentieth centuries, they were a major source of cocoa and coffee. See Frynas et al, 2003.

<sup>4</sup> In fact, the table may underestimate the importance of oil relative to STP's population, since some projections indicate that output could rise swiftly from the 2011-2015 average to reach over 100,000 barrels per day (i.e. about 175 barrels per head per year) by 2017.

**TABLE 1**  
**Oil Production Relative to Population in Selected**  
**African Countries**

	<b>Barrels per day 2002 (thousands)</b>	<b>Population 2002 (thousands)</b>	<b>barrels per year per capita</b>
Angola	916	13,121	25.5
Cameroon	96	15,769	2.2
Congo-Braz.	261	3,657	26.1
Eq. Guinea	221	482	167.4
Gabon	275	1,315	76.3
STP	70*	180**	141.9

\* currently projected average output over the period 2011-2015.

\*\* average 2011-2015, assuming an annual growth rate of 2%.

**Sources:** World Development Indicators, IMF, Frynas (2003).

5. One of the most important ways in which the advent of oil will affect STP is that it will lead to a drastic reduction in the amount of foreign external financial assistance on concessionary terms, and on which the country is currently so dependent. STP will cease to be an LDC and a beneficiary of IDA. This is fully recognized in the PRSP, as is the transitory nature of the oil wealth. This is why diversification of production and exports to generate alternative sources of income in ways which will most effectively benefit the poor (and especially the rural poor) is at the heart of STP's poverty alleviation strategy. At the same time, Sao Tome must avoid the pitfalls of other oil-producing countries in Sub-Saharan Africa and elsewhere. The major issue here is the management of the oil revenues. This must not only be prudent, in order to avoid or minimize macroeconomic imbalances. Equally important is the use of the revenues for key social and infrastructure programs which will have the greatest impact on poverty reduction. To this end, in Chad, another new African oil producer, an Oil Revenue Management Program has been put in place with the support of the World Bank<sup>5</sup>. The practical application of this program,

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<sup>5</sup> Key features of the Program include: (a) a "Future Generations Fund" into which 10% of the oil dividends and royalties will be placed; (b) allocation of the bulk of the remaining funds for additional spending in priority sectors (health, education, rural development, infrastructure, and environment) and a 5% share development in the oil-producing zone; (c) an Independent Oversight Committee, a body of nine members, the majority of which represents local Civil Society organizations, including representatives of labor unions, religious groups, women organizations and the Parliament, to ensure that oil revenues are channeled into development projects in priority sectors, and guard against waste or misuse of these funds. The oversight committee is being advised and monitored by the World Bank and the United States Treasury; and (d) a dedicated offshore escrow account, into which the consortium of companies (led by ExxonMobil) will initially place all revenues (royalties, dividends, taxes and customs duties). The Government of Chad and the Oversight Committee will regularly audit this account, the audits will be monitored by the World Bank to ensure that Chad is receiving its share.

which aims to ensure that at least a significant proportion of oil revenues are directed to key social and infrastructure expenditures, may provide important lessons for STP.

6. The impact of oil will be felt long before the start of production itself. Contract signature bonuses, worth about US\$40 million, are expected before the end of 2004, and further bonuses and other advance payments will likely follow during the ensuing years. The Authorities face the challenge of administering these relatively vast, but temporary, resources against the background of significant institutional weaknesses, especially in public financial management and accountability for the use of public resources.

7. In addition to these revenue management and governance dimensions, oil will present two further policy challenges to STP. The first is the so-called “Dutch disease,” whereby the development of a large-scale natural resource has damaging side effects on the rest of the economy through upward pressure on the exchange rate and domestic prices as the growing natural resource center competes for goods and services. In the absence of compensating measures, these factors would lead to a serious erosion of STP’s competitiveness in non-oil tradables. Even more significant for STP is likely to be the second challenge – the probability that the oil sector will tend to form an “enclave” with minimal linkages to the rest of the economy<sup>6</sup>. This would mean that the direct impact of oil exploitation on employment, incomes, and hence poverty, would be very limited. If these issues are not addressed, there is a considerable danger that STP would follow in the tracks of other low income oil exporting countries in Sub-Saharan Africa and elsewhere, which have seen an exacerbation of corruption, inequality, poverty and ultimately civil conflict in a context of deteriorating environmental conditions.

8. The appropriate policy response to the challenges posed by the coming oil era would therefore be a judicious mixture of (a) adequate macroeconomic management of oil revenues; (b) putting in place a practical system for revenue allocation aimed at ensuring that the bulk of them are geared towards poverty-reducing expenditures; (c) strengthened public sector financial management and better governance; (d) encouraging the growth and development of non-oil sources of income through improved efficiency, market access and flexible factor prices, and through the creation of a more favorable environment for business and investment; and (e) strengthening core skills and capacity to enable a wider proportion of STP’s population (especially the poor) to benefit from enhanced trade and from future oil-related opportunities, such as the provision of basic services to the oil industry and its personnel<sup>7</sup>.

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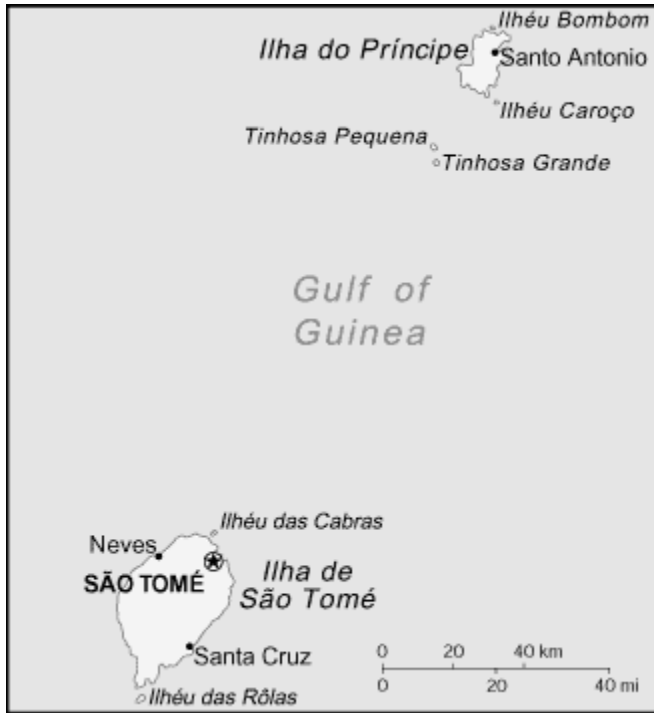
<sup>6</sup> This would stem from the capital intensive nature of the sector, the use of expatriate staffing and a large reliance on imports, not only for relatively sophisticated inputs, but even for basic supplies of goods and services, given the limited ability of the local economy to respond to the demand.

<sup>7</sup> Because oil revenues are not expected to flow for at least another seven or eight years, some of these capacity-building investments would be for the medium term. Nevertheless, a strategy aimed at maximizing “local content” of oil company expenditures, needs to be developed as soon as possible so as to ensure that STP is ready in time. This is of particular importance given the fact that the offshore oil blocks are to be shared with Nigeria, which will therefore be a competing source for many services.

**9. Objectives of the study.** The principal objective of the DTIS is to review the constraints which impede a diversified and expanded trade performance by STP, and to make prioritized and sequenced recommendations for policy reform and technical assistance to remove them. Thus, while all the policy responses mentioned in paragraph 8, and their implications, will be discussed, the analytical focus will be on the trade-related dimensions, especially points (d) and (e). Cross references will be made to complementary work, previous and ongoing, which covers other aspects of the country's development and poverty alleviation strategies. In line with IF terms of reference, the proposed DTIS would include: (a) an assessment of the country's current and medium term macroeconomic environment and of the specific constraints that it faces in accessing world markets, both currently and in the light of expected oil-related developments; (b) an analysis of the country's trade performance and a review of the formulation and implementation of its trade policy, with particular emphasis on its integration with the national poverty-reduction strategy; (c) an assessment of the constraints preventing or hindering an expansion and diversification of products and services for export, including the investment climate, lack of marketing infrastructure, lack of skills and technical support, and other "behind-the-border" hurdles; (d) the identification of key sectors for the expansion of output, exports and employment; and (e) concluding recommendations for policy reforms, institutional capacity implications, and action plans to remove the bottlenecks and seize the opportunities identified in the diagnostic study. A proposed outline of the DTIS is included at the end of this concept note. The study's conclusions and recommendations would be endorsed by the Government of STP, following broad based consultations with all stakeholders in the context of a national workshop. The DTIS would subsequently be mainstreamed into the country's development strategy (PRSP) as well as other donor support instruments such as the World Bank Country Assistance Strategy (CAS).

## 2. Socio-economic context

### 2.1 Overview



10. The Democratic Republic of São Tomé e Príncipe (STP) is a small island country located in the Gulf of Guinea some 400 kilometers to the west of Gabon. It has a population of about 150,000 and a land area of just over 1,000 square kilometers. While the archipelago includes several islands, most very small, the population is concentrated only on the two largest – São Tomé itself and Príncipe. Only about 7,000 people are permanent residents of Príncipe. The population is increasing at about two percent per year. STP is one of the poorest countries in the Sub-Saharan African region with a per capita income of about US\$300 in 2002;<sup>8</sup> it is designated as a Least Developed Country (LDC). Nearly half the population lives in the countryside, although urbanization is accelerating. The economy is dominated by services (68 percent of GDP) and agriculture (18 percent). Manufacturing industry is very small, accounting for less than five percent of national output. There are no major foreign investments outside the tourist sector, though these may appear once petroleum-related activities start. The location of the islands presents its people with substantial potential opportunities which remain largely unexploited. There are also significant possibilities for eco-tourism – the forests on the island contain unique species of flora and fauna.

11. Since 1991, STP has been transformed from a Marxist one party state into a pluralist democracy. Mr. Fradique de Menezes was elected President for a five year term in STP's

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<sup>8</sup> World Bank: "World Development Indicators," 2003

third multi-party presidential election in July, 2001. In March 2002, National Assembly elections were held in which no party secured an overall majority. New presidential and parliamentary polls are due in 2006. Elections were fair and have been held in a peaceful atmosphere. The approaching oil era, however, is already having a disturbing impact on STP's young democratic tradition. Tensions stemming in part over disputes concerning the use to which signature bonuses and other advance payments would be put, led to an attempted coup d'état in July 2003. This was ended after a week by a negotiated settlement that allowed the return of President de Menezes and the Prime Minister. The attempted coup and related events have not diminished the commitment of the Prime Minister and her Government to the economic policies in place prior to the coup. However, the actions underline the somewhat delicate political background to the country's approaching transformation and the need to forge agreements on economic policy with domestic stakeholders<sup>9</sup>.

12. STP is not a member of the WTO but has observer status. The DTIS (outline, section 2.6) will examine the issue of the timing of possible full STP membership of the Organization, the benefits which the country would obtain, and the capacity building requirements both for the application process and for membership itself.

13. STP is one of the eleven members of the Economic Community of Central African States (ECCAS).<sup>10</sup> Although the stated aim of the members of ECCAS is to form a common market, there is as yet little integration between them. STP's closest relations within the grouping are with Angola and Gabon, but both of these are dwarfed by the increasingly important interchange with Nigeria, not only on the economic front, but also politically and diplomatically. This stems entirely from the fact that most of São Tomé's potential offshore oil reserves are to be jointly exploited with Nigeria, with the latter receiving 60 percent of the proceeds. There is a substantial amount of informal trading with Nigeria (see paragraph 27). Also more significant than ECCAS is STP's possible future relationship with the Central African Economic and Monetary Community (CEMAC<sup>11</sup>). This issue is discussed in more detail in Section 3.2 of this concept paper.

14. STP's exports of goods and services have for some decades been far less than sufficient to meet the country's import needs, and the deficit on the current account of the balance of payments was close to half of GDP in 2002. This very large gap is financed through grant aid and borrowing, much of the latter on concessional terms.

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<sup>9</sup> While oil certainly played a role in the coup and surrounding events, it was by no means the only, and perhaps not even the principal, cause. The timing, above all though, was oil-influenced, since the rebels wanted to denounce the unequal distribution of the country's resources before the oil revenues arrived. The coup was sui generis and true to STP's non-violent tradition since no-one was hurt, normal life went on as usual throughout the week, and the detained government members were well-treated. For further details, see Seibert, 2003.

<sup>10</sup> The other ten are Angola, Burundi, Cameroon, the Central African Republic, Chad, Gabon, The Republic of Congo, the Democratic Republic of Congo, Equatorial Guinea, and Rwanda.

<sup>11</sup> As the grouping, which is composed of Cameroon, Chad, Central African Republic, the Republic of Congo, Gabon, and Equatorial Guinea is more commonly known by the initials of its French name (Communauté Économique et Monétaire de l'Afrique Centrale), we will use these initials in this paper.

15. STP operates a flexible exchange rate regime which is currently classified as “managed floating.”<sup>12</sup> Between the end of 2001 and the end of 2003, the official exchange rate moved from 9,192 dobras per US dollar to 9,541, an annual depreciation rate of about two percent. The real effective exchange rate depreciated by 6.5 percent in 2001, 5.2 percent in 2002 and 4.5 percent in 2003. Currency can be freely exchanged both at banks and through informal trading. The spread between official and parallel rates has been less than one percent since 1999, and the parallel market is mainly used by those who wish to avoid paying taxes and bank fees which currently amount to some 3 percent of each transaction. It is hoped that greater banking competition would lower fees and hence reduce the incentive to resort to the parallel market.

16. The informal sector is very important in STP, though there are no reliable estimates of its size. According to the Direction of Commerce, a significant percentage, and perhaps a majority, of the commercial transactions carried out within the islands is informal. A broad range of highly labor-intensive activities in both rural and urban areas are carried out by micro enterprises, nearly all of which operate informally. The informal sector’s participation in foreign trade is more limited but would appear to be growing in significance. Given the importance of the informal sector, official statistics on per capita income and other variables are subject to considerable uncertainty.

## **2.2 Recent Economic Developments**

17. The World Bank and the IMF have been supporting STP’s stabilization and structural adjustment programs for some years. Following a decade of very large macroeconomic imbalances, the Authorities have, since 1998, pursued more successful economic and financial policies. At the same time, dependence on cocoa has been reduced as tourism and construction have increased their contribution to economic growth. Macroeconomic policy implementation was supported by an IMF Staff Monitored Program (SMP) in 2002, after a three year Poverty Reduction and Growth Facility (PRGF) went off track in early 2001<sup>13</sup>. The IMF considers performance under the SMP and in 2003 to have been broadly satisfactory.<sup>14</sup>

18. Better economic management has helped to raise real GDP growth, reduce the primary budget deficit and lower inflation.<sup>15</sup> The improved fiscal performance reflects a

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<sup>12</sup> IMF, 2004.

<sup>13</sup> Spending overruns were triggered by petroleum contract bonuses, election-related expenditures, a 25 percent public sector salary increase and a loan to the public electricity company.

<sup>14</sup> IMF, 2004.

<sup>15</sup> Annual real GDP growth rose from an average of 1 percent between 1985 and 1997 to 2.7 percent between 1998 and 200 and then to over 4 percent from 2001 onwards. The primary fiscal balance (including HIPC-Related social expenditure but excluding oil revenue, grants, interest earned, scheduled interest payments and foreign-financed capital outlays) fell from nearly 13 percent of GDP in 2001 to 4.3 percent in 2002, which was actually better than targeted under the IMF Staff Monitored Program. The inflation rate fell from over 80 percent at the end of 1997 to an average of 9 percent between 2000 and 2002.

significant increase in tax revenues from 13 percent of GDP in 1998 to an estimated 20 percent in 2003, while over the same period current expenditures in relation to GDP were held roughly constant. The main outstanding fiscal preoccupation concerns the need to sterilize future oil sector proceeds and to limit the non-oil primary fiscal deficit to the dividend and interest earnings from the accumulated oil financed assets. This issue is likely to be central to discussions with the IMF during 2004 concerning a possible new three-year PRGF arrangement.

**TABLE 2**

**São Tomé e Príncipe:**  
**Selected Economic Indicators**

*(Annual percentage changes)*

	<b>2001</b>	<b>2002</b>	<b>2003 (est.)</b>
Real GDP	4.0	4.1	4.5
Consumer prices	9.5	9.2	9.6
Real effective exchange rate	-6.5	-5.2	-4.5
Terms of trade	10.8	52.7	-11.2

*(in percent of GDP)*

Gross domestic investment	35.8	32.8	30.4
Gross domestic savings	-23.1	-12.5	-9.4
Non-oil current account balance	-65.3	-51.0	-44.7
Overall fiscal balance*	-22.2	-13.2	-14.5

\*Including grants

**Source:** IMF, 2004.

19. Since the early 1990s, the Authorities have attempted a number of structural reforms, but these have frequently been incomplete. Currently outstanding priorities include: (a) an in-depth reform of the formulation, execution and monitoring of the budget, including mechanisms permitting greater and more transparent accountability for the use of public resources; (b) development of a petroleum sector strategy and enactment of a law governing the petroleum sector; (c) training and capacity-building in the public sector to strengthen management and governance; and (d) deepening of recent civil service reform efforts, including the restructuring and redefinition of employment categories and salary scales. Further and equally urgent reforms are required to improve the business climate more generally, and notably in the rural sector through the establishment of proper land titling and the provision of technical support to farmers. These are directly relevant to the

DTIS and are discussed in Section 4.4 of this concept paper. Many of these reforms would be supported by a proposed World Bank technical assistance credit.

20. Improved macroeconomic performance and growth have so far had little or no effect on the alleviation of poverty. Poverty in fact worsened between 1997 and 2000 as a result of external shocks, the low level of domestic savings, lack of access to land and capital, and low overall productivity. A 2001 poverty profile identified 54 percent of the population as poor and 15 percent as extremely poor. Poverty is above all a rural phenomenon, with 65 percent of the rural population below the poverty line and 22 percent living in extreme poverty.<sup>16</sup> An estimated Gini coefficient of 0.59 indicates that the distribution of income and wealth is highly unequal. This may well partly explain the inability of the poor to benefit significantly from higher growth.

21. The over-riding question is how to accelerate growth and distribute its fruits in such a way as to benefit the poor and raise living standards for all segments of the population. For a small, open economy like that of STP, greater participation in the global economy would play a central role in resolving this issue. Given the country's natural advantages, the best hope would appear to lie in diversified, smallholder agricultural products destined for the export market and in the development of services related to the islands' tourist attractions on the one hand and to the oil industry on the other.

### **3. STP's Foreign Trade**

#### **3.1 External Sector Performance**

22. The very high ratio of imports to GDP (84 percent, on average, between 2000 and 2002) indicates the extreme openness and vulnerability of STP's economy. The ratio is well in excess of the average for small, open economies on the Sub-Saharan African mainland, though comparable with that of other small island economies. By contrast, exports represent an average of only just over one third (34.3 percent) of GDP, reflecting STP's large structural trade deficit. The deficit is financed almost entirely by overseas aid in the form of grants and concessional credits.

23. STP's goods exports are dominated by cocoa which accounts for about 90 percent of goods export receipts.<sup>17</sup> Cocoa export earnings have shown a long term downward trend for several decades, but which accelerated in the 1990s. They are, moreover, affected by a high degree of price volatility, with earnings falling from US\$5 million per year in the mid-1990s to US\$2.9 million in 2000 before rising again to US\$4.7 million in 2002. The accelerated downward trend reflects the loss in production and productivity of the cocoa trees, which are generally old, ill-tended, and infected with pest-born diseases.<sup>18</sup> An issue to be addressed is the extent to which cocoa exports can be revived as a significant

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<sup>16</sup> World Bank, 2003.

<sup>17</sup> Small amounts of copra and coffee are also exported, and air transport of tropical fruits and flowers to Europe has recently started, but on a very small scale.

<sup>18</sup> World Bank, 2003.

foreign exchange earner. Cocoa has been in long term decline, not only since independence in 1975, but in fact since the early 1920s<sup>19</sup>, and it is extremely unlikely that a revival of large cocoa plantation agriculture would be either feasible or desirable. Diversification into other agricultural exports would offer a better perspective and would benefit from STP's natural comparative advantage as a producer of tropical food crops. There may, nonetheless, be some possibility for the production of high quality cocoa on a limited scale for a "niche" market. This will be analyzed the DTIS (outline, section 3.1).

24. STP is among the largest recipients of aid per capita in the world – net annual disbursement of official development assistance has been about US\$500 per person since the early 1990s. Practically the entire public investment program is financed from overseas. It is thus something of a misnomer to describe STP's economy as "cocoa-dependent." Although cocoa is the largest goods export, it has for some years been exceeded as a foreign exchange earner by tourism<sup>20</sup>. Moreover, the value of cocoa exports is little more than the annual interest due on STP's external debt. It would, therefore, be more accurate to describe STP's economy as aid dependent rather than cocoa dependent.

25. Europe accounted, on average, for about 90 percent of exports between 1998 and 2003. The Netherlands and Belgium dominated with 70 percent and Portugal with 20 percent. The strong representation of the Netherlands and Belgium reflects the sale of cocoa on the Amsterdam and Antwerp wholesale markets. Most of the remaining 10 percent of exports is probably destined for continental Africa. Angola has been the principal market there, with an average of 3 percent of exports.

26. Europe is also the dominant source of STP's recorded imports, averaging about 80 percent by value. Within Europe, Portugal is by far the most important partner, accounting for nearly two-thirds of imports in 2002 and 2003. There is some evidence that this high dependency on Portugal, a legacy from STP's colonial history, does result in higher prices for some imported goods than could be obtained elsewhere. However, this needs to be investigated. For Sub-Saharan Africa, Angola is the most important partner, supplying a small but significant 10 percent of imports, followed by Gabon with about 2 percent.

27. Although no attempt has been made to measure it, there are some indications that informal international trade has been on the increase in recent years. Since oil prospects brought STP and Nigeria closer together, informal sector traders from the latter country have made some inroads, and there are reported to be regular charter flights several times a month bringing in clothing (especially second hand clothing from Europe), electric and

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<sup>19</sup> See Frynas et al, 2003.

<sup>20</sup> Cocoa exports averaged US\$4.3 million per year between 2001 and 2003, while tourism receipts averaged just over US\$10 million per year during the same period.

electronic goods and pharmaceuticals.<sup>21</sup> In 2003, the Authorities took some measures to stem the inflow of informal goods and traders, mostly from Nigeria. Containers now have to be un-stuffed in the port or airport area rather than delivered intact to their destination, and the goods must clear Customs in the port or airport on an item-by-item basis. Entry visas can no longer be granted upon arrival at the international airport, but must be obtained before boarding the flight. It is difficult to judge how successful these measures have been in curbing informal trading activities. They are, however, not cost free. By insisting on the un-stuffing of containers in the port, STP is depriving its importers and consumers of one of the benefits of containerization, which is secure door-to-door delivery. According to tourist industry sources in São Tomé, the new visa requirements, about which there was apparently little or no consultation with the private sector, are having a negative effect on tourist arrivals. These issues will be examined in the DTIS (outline, section 2.4).

28. While service exports are dominated by tourism, there have also been attempts to generate hard currency by selling flags and passports of convenience. Several dozen ships, ranging from petroleum tankers to container vessels, fly the Santomean flag, while there are a considerable, but unknown, number of holders of Santomean diplomatic passports. However, the proceeds from these initiatives are very insignificant compared to the volume of foreign grant aid and loans<sup>22</sup>.

29. STP has attracted small amounts of foreign direct investment of the order of US\$3 million per year.<sup>23</sup> This represents about 6 percent of GDP. Although this is a high ratio for the Sub-Saharan Africa region, it reflects the small size of the country's economy rather than its power to attract investors. Most of the investment has to date been in the tourism sector: the largest single private foreign investment was in the 1996 renovation of the capital city's main hotel by German and US interests.

### **3.2. The Trade Regime and the Issue of Regional Integration**

30. **Trade Taxes.** As is common in least developed countries, STP's central government revenue depends heavily on taxation of international trade. Import taxes and consumption taxes on imported goods amount to 55 percent of all tax revenues.<sup>24</sup> Import duties and other trade taxes fall disproportionately heavily on the small formal sector and discourage small and medium-sized enterprises from making the transition to formal status.

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<sup>21</sup> See Frynas et al., 2003. Moreover, in May 2004, a group of Nigerian senators visited São Tomé and reportedly lobbied for a law which would allow free movement of goods and persons between the two countries. There is no indication yet that this reflects the official policy of either Nigeria or STP.

<sup>22</sup> There were reputedly some irregularities in the sale of passport and flags of convenience which reduced still further the amount accruing to the State's coffers.

<sup>23</sup> World Bank: "World Development Indicators," 2003

<sup>24</sup> Total revenues in 2002 amounted to nearly US\$27 million, of which total tax revenues were US\$10.5 million.

31. In recent years, STP has been successful in simplifying and reforming its tariff structure. Although there is still considerable room for improvement in collection practices, the problems prevalent in the 1990s – when substantial ad hoc exemptions seriously reduced the take of import duties and consumption taxes – seem to have been largely solved. In 2000, the tax register was updated and the SYDONIA computer system became operational in Customs. The 2000 budget also introduced significant trade liberalization measures. The obligation to surrender export receipts to the central bank was abolished, all non-tariff barriers were removed, and current account transactions were liberalized. Export taxes were eliminated. Following a comprehensive reform of customs tariffs in the same year, the import tariff structure has been simplified to three rates and tariffs lowered; the highest rate is now 20 percent.<sup>25</sup> There would therefore appear to be no significant outstanding issues with regard to the structure of trade taxes. Problems related to collection and Customs procedures will be analyzed in the DTIS (outline, section 2.2).

**32. Regional Integration and the Economic Partnership Agreement (EPA) between STP and the European Union (EU).** Currently, the only formal trade grouping to which STP belongs is the ECCAS. Little integration or harmonization has yet taken place, but further information on the trade policies of ECCAS and their potential impact on STP is needed. Of more immediate concern is São Tomé's upcoming negotiation of a new EPA with the EU. The Cotonou Agreement provides for negotiation of EPAs between the EU and Sub-Saharan African countries. The new arrangements are scheduled to take effect in 2008 when the existing Cotonou Agreement expires. The main objective of these EPAs is to modify trading arrangements between the EU and its ACP partners to make them more effective in stimulating trade and investment and more compatible with WTO rules.

33. While an EPA could have some advantages for STP,<sup>26</sup> it also presents significant challenges. First, the EPAs include a provision for reciprocity in preferential tariff reductions and eliminations. While this may, through the application of the Most Favored Nation principal, not lead to a complete reciprocity of duty-free access, it would nonetheless imply a significant reduction in duties on goods originating in the EU. In the case of São Tomé, this would undermine a major generator of tax revenue. Alternative sources, such as higher taxes on factor incomes or the creation of a new value-added tax, would have to be found to compensate for this. Implementation of these new taxes is not an easy or cost-free exercise, especially in an LDC. Second, the reduction or elimination of duties on imports from the EU may threaten certain economic activities in the country.

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<sup>25</sup> The three rate bands are 5 percent c.i.f. on basic goods, 20 percent on luxury goods, and 10 percent on all other goods; the majority of investment goods are taxed at 10 percent. Special surtaxes are applied to petroleum products (between 9.4 percent and 322 percent depending on the product) and alcoholic beverages (where rates range between 45 percent and 75 percent).

<sup>26</sup> These include assured continued duty-free access to the EU market (though it should be remembered that this access is only the first hurdle; complying with phyto-sanitary and other regulations is often more difficult), encouragement of new product development for export to Europe, related technical assistance (including private firm-level cooperation) and financial support, lower consumer and input prices (provided, of course, that the EU is the lowest cost provider for the goods in question), and eventually greater international competitiveness.

This effect is not likely to be of great importance in STP since there are comparatively few local enterprises which compete directly with European imports. Moreover, informal duty-free imports of a range of consumer goods from or via Nigeria already exist. Third, for practical reasons, the EU has expressed its intention to agree and sign each EPA, not with individual countries, but with regional economic blocs. In principal, therefore, STP would need to choose “its” bloc, which, given its location, would have to be either CEMAC or ECCAS. Given the relatively limited degree of harmonization and integration achieved in ECCAS to date, the likely preference of the EU would be for CEMAC.

34. The possible future relationship between STP and CEMAC is a major issue in the country. STP could derive certain advantages from membership of CEMAC. These would include easier access to CEMAC country markets and possible peer pressure to reform policies and institutions.<sup>27</sup> On the other hand, membership of CEMAC has significant implications which go beyond trade. Perhaps chief among these is the fact that CEMAC is also a monetary union, whose common currency (the CFA Franc) is tied to the Euro. While this may provide a degree of monetary stability, it also means exchange rate rigidity, which could have serious implications for the country’s competitiveness and range of possible trading options, especially when added to the macroeconomic impact of future oil revenues.

35. The extent to which STP already has preferential access to the CEMAC market or whether such access could be negotiated short of full CEMAC membership is unclear.<sup>28</sup> Irrespective of the formal situation, access would not appear to be easy at present. Practical difficulties in penetrating, for instance, the Gabonese market, were reported to the Identification Mission. Agricultural produce from STP was being sold on a small scale in Gabon, but following protests from fellow CEMAC member Cameroon, which wished to supply the Gabonese market with the same or similar products, measures were taken to block STP access. Most trade seems to take place on an informal basis. A draft commercial accord has been drawn up by the CEMAC secretariat, on which the STP Authorities have made critical comments.

36. An alternative to an EPA, with or without accompanying membership of CEMAC, would exist for STP. A country designated as Least Developed, be it an ACP country or not, is eligible for preferential access to the EU market without reciprocity obligations under the “Everything But Arms” initiative<sup>29</sup>. However, while this alternative does have short term attractions, it also carries risks. First, in principle, the concessions, unlike those enshrined in an EPA Treaty, may be removed at any time, though that is improbable.

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<sup>27</sup> For example, initiatives to harmonize business laws and commercial regulations and to establish internationally acceptable accounting standards and practices through OHADA, adoption of a common external tariff, etc. However, membership of CEMAC is not a precondition for the adoption of the OHADA legal, regulatory and accounting frameworks.

<sup>28</sup> As is, for that matter, whether a relationship short of full membership would satisfy EU EPA negotiating requirements.

<sup>29</sup> STP also enjoys preferential access through the US Generalized System of Preferences, and has been approved for duty free access under the US Africa Growth and Opportunity Act though it does not possess a clothing visa under the latter.

Second, and more serious for STP, would be the almost certain loss of LDC status once significant oil revenues start to flow. Third, refusal of an EPA may diminish the volume and quality of EU financial and technical support, though this is likely to be only in the longer term, when the flow of financial and technical assistance on concessionary terms would have diminished anyway because of petroleum revenues.

37. The complex issue of the future trading relationship with the EU, and the related question of regional integration, would, *a priori*, merit in-depth investigation in the DTIS (outline, section 2.3). However, STP has already commissioned a study, financed by the EU, to examine the impact of an EPA. This is currently being carried out by consultants, and a first draft is due in early June, 2004. A first step, therefore, would be to examine this work carefully to determine whether it covers adequately the range of issues identified in this concept paper. Only then could the necessity for further work, and its extent and depth, be determined.

**38. Export and Investment Promotion.** STP is giving serious consideration to the development of free trade zones (zones franches) where imports destined for export production or re-export would be exempted from tax. In certain cases, the zones could equally be used as bases for the supply of goods and services to offshore oil platforms. A free zone authority has been established, of which the chief executive is a former Minister of Commerce, and which has a board of directors an office, and a skeleton staff. A concession has already been made to a South African business, on reportedly extremely favorable terms, for managing a free trade zone on the island of Príncipe. This concession covers about one-third of the island's area and includes the possibility of building a logistics center for offshore oil platforms and permission to undertake substantial logging.<sup>30</sup> Thus far, the project has stalled and it seemed at one point as if it might never take off due to lack of funding. It is, however, possible that the advent of oil will breathe new life into the scheme. Other zones are contemplated on São Tomé island, including an export processing and storage (including cold storage) zone near the international airport and in the vicinity of an eventual deep water sea port. The DTIS (outline, section 2.5) will examine the issue of the development of free zones in STP. Experience with them, in Sub-Saharan Africa and elsewhere, has been mixed. Their benefits may be limited and their potential costs, both hidden and apparent, quite high, as is shown by the experience of a number of countries. It is difficult to see why export promotion measures should be confined to certain geographical areas rather than introduced into the country as a whole; in any event, importing for export production is likely to play a small role in STP given the extremely low base of industrial output and infrastructure. The zones may also erode fiscal revenues and encourage fraud and corruption. Their administration is complex, and strong management has been crucial to the accomplishments of the relatively few success stories such as Taiwan and Mauritius.

39. STP's investment code offers a wide range of tax exemptions and other incentives, but has been remarkably unsuccessful in attracting foreign investment. This is partly

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<sup>30</sup> This is doubly worrying since the South African company concerned is reportedly associated with Malaysian interests which have been involved in unsustainable logging activities in a number of Sub-Saharan African countries, including Equatorial Guinea. For further details, see Frynas et al., 2003.

because fiscal incentives are relatively insignificant in relation to the high costs of doing business in STP (see Section 4.4), but also because procedures for setting up a business are lengthy, complex and costly, despite the code. A new code has been prepared, which envisages, inter alia, the establishment of a one-stop window (“guichet unique”) for new investors, but has not yet been passed into law. The issue of investment promotion is closely related to that of the development of free zones, and will also be analyzed in the DTIS (outline, section 2.5).

40. Technical Assistance and Capacity Building. STP has not benefited from JITAP and has received relatively little trade-related technical assistance. The Direction of Commerce informed the Identification Mission of its need for capacity building in the areas of regulation of internal commerce and trade support for exporters.

#### 41. High Priority Trade Issues.

- There is an overwhelming need to increase and diversify both goods exports and those of services. STP’s location and natural advantages offer significant opportunities for this, but if they are to be seized, then serious constraints must be overcome. These constraints are discussed in Section 4 of this Concept Paper and will be analyzed in the DTIS (outline, section 4).
- While a return to large scale cocoa production is neither desirable nor feasible, the possibility of smallholder production of high quality cocoa and coffee for a “niche” market warrants investigation (DTIS outline, section 3.1).
- The quantity and impact of informal trading, principally with Nigeria, needs to be analyzed to the extent possible. It is important that measures to deal with it do not have collateral damage in other promising sectors (DTIS outline, section 2.4).
- The issue of STP’s trading relationship with the EU in the light of upcoming EPA negotiations between the EU and Sub-Saharan African countries, as well as the related question of STP’s possible integration into regional trading blocs, need to be carefully analyzed. Options need to be identified and the consequence of each choice evaluated. The necessity, depth and extent of this work in the DTIS can only be determined after examination of an ongoing study of the impact of an EPA in STP (DTIS outline, section 2.3).
- STP’s apparent policy of promoting the development of free zones needs to be carefully evaluated (DTIS outline, section 2.5).
- The effectiveness of current commercial regulation and support to exporters, fiscal and otherwise, should be examined and appropriate capacity-building needs identified (DTIS outline, sections 2.5 and 4.5).

#### 4. Constraints to Greater International Competitiveness.

42. There are a number of closely interrelated constraints which together explain STP’s poor performance as a goods exporter:

- Geographic isolation and high international air and sea transport costs.<sup>31</sup> This is in large part attributable to the high costs and low efficiency of infrastructure directly related to international trade (sea port, airport etc.).
- High local costs due to low factor productivity;<sup>32</sup> insufficient, high cost and poor quality infrastructure (road transport, utilities etc.); and excessive costs of credit (even when available).
- Low supply response, notably in agriculture, which renders enhanced competitiveness from exchange rate flexibility largely moot.
- The high costs of establishing and carrying out a business and an unsupportive institutional environment for trade.
- A low level of human capital formation and consequently low labor productivity, reflecting not only poor technical preparation, but also the debilitating effects of endemic malaria.

These issues would be analyzed in depth in the DTIS (outline, section 4). The following paragraphs examine them in more detail.

#### 4.1 Geographic Isolation and High International Transport Costs

43. STP is extremely poorly served by international shipping and air services. Shipping is infrequent and very expensive. The international airport is served by only three flights per week from Europe, although even this is a considerable improvement on less than two years ago when the only service was a weekly one from Transportes Aéreos Portugueses (TAP). Thanks to competition introduced by Air Luxor, passenger fares have been reduced but, except where special deals are offered, are still high by international standards. Air cargo services are few and far between. There are no regular cargo flights to Europe, and the small exports of flowers and tropical foods are transported in the holds of the passenger aircraft. There are several charter flights per month from Nigeria and two services per week in a small turbo-prop aircraft from Libreville, Gabon.

44. The poor shipping and air services are attributable to a considerable degree (though not entirely) to the inadequate and antiquated state of the infrastructure directly serving international transport. There is no deep water sea port in STP. Even the smaller, shallow draft vessels which serve the islands must, therefore, anchor several hundred meters out from the quays of the existing port in the city of São Tomé, and the cargo must be transported to and from the ships in barges. When it reaches the dock, the cargo must be unloaded from the barges with the port's only and partially functional crane. These slow and inefficient procedures increase both direct and indirect shipping costs substantially. STP cannot benefit from economies of scale in shipping or from the container revolution. Shipping charges are high, reflecting both the long time spent in port and the small size

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<sup>31</sup> These have also had a negative impact on cocoa exports. The Identification Mission was informed that, because of the lack of direct shipping links, cocoa from STP frequently has to be transshipped in Angola. The long transit time leads to deterioration in the quality of the product and hence the prices it can fetch on the European wholesale markets.

<sup>32</sup> Productivity, certainly in cocoa production, and probably in agriculture more generally, is low even by Sub-Saharan African standards.

of the vessels. The vessels currently serving the islands are becoming increasingly rare in international sea transport, and their maintenance and crew costs are high.

45. The international airport is served by a runway of only 2,200 meters which limits the size and configuration of intercontinental jet aircraft which can use it. Even those which do,<sup>33</sup> incur significant costs due to the poor condition of the runway.<sup>34</sup> In addition, terminal building, air navigation and other facilities are well below international standards. Security services are extremely lax.<sup>35</sup> There are no storage facilities for air cargo.

46. The STP Authorities are fully aware of the inadequacies of the country's international transport infrastructure, and aid donors are already supporting the search for solutions. A preliminary evaluation of sea and airport development was included in the "Master Plan for São Tomé e Príncipe," prepared with Taiwanese support, while the United States are financing more extensive feasibility studies of the options for a new deep water sea port and improvements to the international airport.<sup>36</sup> These studies, which are due to start in June 2004, are expected to be completed by the end of the calendar year. Even if this rather ambitious timetable is adhered to, the final results of the study would not be available to the IF team. The team will, therefore, liaise closely with the Ministry of Public Works, as well as with the consultants and relevant US personnel, to follow progress on the study and obtain as accurate a view as possible of the likely recommendations.

47. Even after the studies are finished, there will, of course, be a time lag of several years before actual construction is completed. The earliest date at which STP could realistically count on having an operational deep sea port is 2007, and even that assumes both procedural agility and a relatively simple and cheap facility, such as a single extended jetty. In the meantime, therefore, it is important to examine how current services could be improved and costs lowered, even in the absence of these improvements. In the port, the DTIS will examine the extent to which current port administration and customs procedures exacerbate delays and increase costs for both exports and imports, and whether relatively small and low cost additions or improvements to the existing infrastructure could improve operations. Nonetheless, with regard to shipping services, it is unlikely that there can be much progress in the absence of deep water facilities. In the case of air transport, there may more scope to lower prices and increase access, even while waiting for the airport extension. The DTIS will investigate these possibilities (outline, section 4.1).

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<sup>33</sup> TAP and Air Luxor use Airbus 300 jets which have relatively short take off and landing capabilities.

<sup>34</sup> It was reported to the Identification Mission that aircraft tires must be fully changed after every three landings at São Tomé international airport.

<sup>35</sup> The DTIS Team Leader and his fellow passengers were able to board their departing flight on May 4 2004, without any security check whatsoever.

<sup>36</sup> The cost of the studies, financed by USDTA, is US\$800,000, \$450,000 for the sea port and \$350,000 for the airport.

## 4.2 High Local Costs

48. Poor, or even non-existent, road links prevent or hinder agricultural production from many parts of São Tomé island from reaching the market in a saleable form. This problem is accentuated by the climate – STP has a very short dry season and the rainfall in some parts of the islands is among the heaviest in the world. This washes out dirt roads, or renders them impassable, even for four-wheel drive vehicles, for much of the year. The island of Príncipe as a whole is isolated. It is served on a daily basis by a small turbo-prop aircraft and by a public ferry service consisting of two rather flimsy converted fishing vessels,<sup>37</sup> one of which was recently lost. This makes the transport of, for instance, heavy construction equipment or building material virtually impossible for those who do not possess their own ocean-going vessels.

49. Although STP possesses abundant hydro resources, as well as the possibility of using alternative generating power such as wind and sun, the country relies almost entirely on expensive oil-fired generation for its electricity. Moreover, the service is unreliable, and even in the capital city, institutions such as hotels and those which use sensitive electronic equipment must maintain their own generators. The state-owned electricity company also manages the potable water supply which is of low quality and subject to frequent and lengthy interruptions. Supply is, moreover, largely restricted to the capital city. Sewage services are very limited and most waste matter is piped untreated into the sea. International telecommunications are reasonably reliable for the comparatively small proportion of the population which has access to them, but they are expensive: a call to Europe costs over one US dollar per minute during peak hours. The country has seen a recent boom in internet usage and this service becomes chronically overloaded during business hours. Use of cellular phones has also greatly expanded over the last two years, although the effect of this on prices has been muted by the fact that the cellular service is owned by the state telephone company. At the end of 2005, the telecommunications market will be opened to competition. The regulatory framework is being put in place with World Bank support.

50. The extent to which other donors and/or the private sector are actually or potentially engaged in supporting improvements in domestic transport and utilities (including sea transport to and from Príncipe) will be determined in more detail. The DTIS will analyze the difficulties these sectors present for international trade as well as any gaps which may exist in current or proposed programs (outline, section 4.2).

51. **The financial sector** represents a major constraint to trade and business development. Credit is very difficult to obtain at all, except for a handful of larger enterprises, and even for them, it is extremely expensive. The Chamber of Commerce and associations of private entrepreneurs informed the Identification Mission that interest rates on dobra-denominated credit are of the order of 30 percent per year. This represents a very large

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<sup>37</sup> The roughly 160 kilometer voyage takes about 10 hours under good weather conditions.

spread over the cost of money to the banks (the central bank reference interest rate is currently 14.5 percent) and reflects the high costs and inefficiencies of the banking system, as well as the lack of competition. Until recently, there was only one commercial bank operating in STP. During the last 12 months, two more have been added, one owned by Angolan and the other by Cameroonian interests. It remains to be seen what impact their arrival will have on pricing of services, efficiency and willingness to lend. For the overwhelming majority of medium and small enterprises and agricultural producers, credit is barely available from the banking sector at all, and certainly not for projects requiring a multi-year gestation period (for example, new coffee bushes). The commercial bank which, until recently, enjoyed a monopoly, preferred to keep its money at the central bank where it can earn quite good interest rather than risk it by lending. This attitude is perhaps partly understandable given the absence of a tradition of giving and receiving credit and duly paying it back, and the near impossibility of providing reliable collateral thanks to non-existent or insecure titles to assets such as land. Among the reforms needed for a more effective financial sector are: (a) proper land registration and titling, so that land can be used as collateral; (b) strengthening the judicial system to reinforce incentives to repay by enabling creditors to pursue delinquent debtors in the courts and to seize their collateral where necessary; and (c) an educational effort to inculcate borrowers with the proper use of credit and the need to pay it back.

52. Both private and public sector sources expressed the desire for greater government intervention in the financial sector, either through the establishment of development banking institutions or through the creation of official funds and/or guarantees. Given the well-known moral hazard attached to such approaches, and the negative experience of such institutions in other developing countries, it would be desirable to seek other solutions to current financial sector constraints.

53. Building on other analytical work which may be available, the DTIS will examine the constraints to the development of international trade presented by the weaknesses of STP's financial sector and provide recommendations as to how they may be overcome (outline, section 4.2).

### 4.3 Low Supply Response

54. STP is characterized by a failure to respond adequately to existing or potential external demand, particularly in the agricultural sector. This is reflected not only in the long term decline of cocoa production, but also in the manifest difficulties of introducing alternative exportable crops on a sustainable basis despite favorable natural endowments.<sup>38</sup> The phenomenon is in part due to factors already mentioned, but also to high input prices (thanks in part to almost exclusive reliance on imports); the lack of local marketing infrastructure (access roads, post-harvest processing and conservation, storage facilities, cold and otherwise, etc.); lack of technical support; and to a *de facto* low

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<sup>38</sup> For example, a European entrepreneur is successfully marketing small quantities of high quality coffee. He would like to be able to market more but the supply is simply not forthcoming. Similarly, a number of donor-supported projects for supporting diversified crop production have come to grief soon after the end of the phase of direct donor support and financing.

priority attached to the rural sector by policy makers.<sup>39</sup> The DTIS will include an in-depth study of the factors hindering supply response in the rural sector and develop recommendations for overcoming them (outline, section 4.3).

#### **4.4 The Business Environment**

55. STP is a high cost and difficult country in which to do business. The chief problems and constraints have been described in detail elsewhere.<sup>40</sup> Key priorities include (a) reform of the judicial and regulatory system focusing on the antiquated commercial, penal and civil codes, and the expediency and quality of judicial services; (b) streamlining of the lengthy and complex procedures for the licensing and registry of enterprises and the resolution of business disputes; (c) modernization of the bankruptcy laws; (d) reform of the legal system governing the recovery of loans; and (e) revamping the land tenure system and establishing proper land titling. Some of these issues are already being addressed through other initiatives, such as a World Bank technical assistance credit which is currently under preparation. The DTIS will examine each of them and carry out further analytical work as necessary (outline, section 4.4).

#### **4.5 Human Capital Formation and Productivity.**

56. This area has been identified in the draft PRSP as a significant constraint which hinders the country's development, and as one of the most important causes of poverty. A major program of investment in human capital via improved education and health facilities is required to maximize the ability of the population to adapt to new technologies and to build on the country's comparative advantages. Although officially reported literacy rates are reasonably high (79 percent), there is a falling trend in school enrolment which will eventually erode the employability of the country's overwhelmingly young population. A more immediate issue is the lack of basic skills (mechanics, masons, carpenters, plumbers, electricians etc.) which, unless addressed, will not only continue to limit development, but also reduce the income which the country could earn through the provision of basic services to future oil industry employees and their families. There is, moreover, a strong capacity building need for the owners and managers of small and medium-sized enterprises. Poor health is another cause of low productivity. Malaria is highly prevalent; as well as killing a large number of children every year, the disease seriously affects the productivity of working adults who suffer from new or recurring infections at least once annually. Taiwan is supporting a malaria eradication campaign, which is crucial to the continued development of tourism. Other donors, notably Portugal and Taiwan, are active in the broader education and health areas.

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<sup>39</sup> In a highly aid-dependent economy, such as that of STP, it is completely rational for policy makers and public sector employees to attach a higher priority to the securing of future flows of external financial assistance than to encourage the sustainable growth of the rural sector.

<sup>40</sup> See especially World Bank, 2003.

57. The DTIS would focus on training needs for basic skills to enhance the capacity of the population to capture the opportunities presented by both STP's comparative advantages in general, and future oil production in particular (outline, section 4.5). Portugal is already supporting STP's government-run Professional Training Center, but the Identification Mission was informed that considerably more support is required for professional and basic skill training than Portugal or other donors seem likely to provide for in their current programs. A shift towards basic skill training may have important implications for STP's educational development strategy and should be thoroughly discussed internally before the next version of the PRSP is developed (this is expected towards the end of 2005).

## **5. Possible Sources of Export Diversification**

58. The list of possible sources of export diversification discussed here is meant to be illustrative rather than exhaustive. In fact, it is difficult to predict which activities may or may not develop, and this should be left to market forces to determine. The sector analyses in the DTIS (outline, section 3) should therefore be regarded as case studies which would enhance understanding of the broader constraints facing all fledgling activities.

### **5.1 High Quality Traditional Products: Cocoa and Coffee**

59. STP has demonstrated its capability to produce cocoa and coffee of a quality significantly superior to the average available on the world market. A "niche" market, with premium prices, would certainly exist for such products. In the case of cocoa, high quality output has not been manifest in recent times due to the accelerated decline of the sector since the early 1990s and to international transport difficulties. The DTIS will examine the feasibility of substituting limited high quality production for the existing cocoa crop including the investments in new trees, inputs, credits, infrastructure, post-harvesting processing operations and other improvements which may be required (outline, section 3.1).

60. In the case of coffee, as already noted, a small amount of high quality output is already marketed and is exported by air. By the late 1990s, there was apparently some 1,000 hectares under coffee, mostly at the Monte Café plantation.<sup>41</sup> Despite substantial investment, productivity declined considerably during the 1990s, with production reaching only 44 tons in 1997 and 36 tons the following year.<sup>42</sup> The natural conditions – soils, climate and elevation – are nonetheless ideal for producing high quality coffee. The decline in production, despite these advantages, and despite the investment which has taken place, may be due to the advanced age of the bushes. The draft PRSP includes a goal of planting 1,000 hectares of coffee by 2010, thus doubling the area under cultivation. Given the care and resources coffee requires, only high value production

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<sup>41</sup> At one time, the coffee beans of Monte Café produced the world's most expensive and most sought after coffee, selling at a large premium and frequently sold out years in advance.

<sup>42</sup> World Bank, 2003.

would be worthwhile for smallholders. The DTIS will investigate the constraints to expanding coffee output and determine how they might be overcome (outline, section 3.,1).

## 5.2 Tropical Food Products and Flowers

61. There would appear to be a considerable potential for expanding food production and flowers in STP for the export market. If this output could be expanded, it could also contribute to greater food self-sufficiency<sup>43</sup> and increase potential sales of agricultural produce to the coming oil sector. A number of studies<sup>44</sup> have shown that smallholder food production can be very efficient in STP and would provide farmers with higher income than cocoa production. Smallholders have shown a tendency to shift to such crops in recent years as choices have been opened up to them.<sup>45</sup> Potential markets would appear to exist, since small quantities of such products have already been exported to Europe by air and to Gabon and Angola.

62. Despite STP's natural comparative advantage, and the apparent success of small pilot operations, the barriers to substantial agricultural production for export should not be underestimated. A full strategy would need to be developed, focusing not only on overcoming the general infrastructure and business environmental constraints, but also on a strong research and extension effort for smallholders to increase productivity, as well as the development of post-harvest conservation and preservation techniques and facilities.

63. Export of food products to markets in Europe and other wealthy regions of the world requires strict adherence to quality and phyto-sanitary standards. In view of this, of the initial difficulties of establishing "niche" markets, and of the substantial investments in research, extension and marketing infrastructure which would be required, the most promising route for STP to follow would probably be to encourage established international food companies to invest in and organize the sector. Successful instances of export diversification in Central and West Africa have relied on this option.<sup>46</sup> Small scale operations, such as the current coffee and flower exports from STP, would be in addition to those of the international companies and would not be squeezed out by them. In order to encourage further local operations, it would be important to develop a capacity to provide fledgling exporters with practical advice on how to break into new markets, market their products and comply with phyto-sanitary and other regulations. This issue would be developed in the DTIS (outline, section 6).

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<sup>43</sup> STP currently receives substantial quantities of food aid as well as commercial food imports.

<sup>44</sup> Kyle, 2002, mentions a study by AGROGES-CINFORMA as well as studies in support of the World Bank's Agricultural Privatization Project.

<sup>45</sup> The cultivation of food crops for local consumption, such as banana, breadfruit, maize, taro and other root vegetables, has increased as small holders have responded to land reform and market signals. Moreover, horticultural products such as spring greens, carrots, cabbages, beans and potatoes have been successfully cultivated in the northern part of São Tomé island for some time. See World Bank, 2003.

<sup>46</sup> For example, pineapple and banana production in Côte d'Ivoire and Cameroon and tropical fruits in Ghana.

64. While the DTIS would explore the possibilities for new agricultural exports (outline, section 3.2), it would also emphasize that the role for policy makers is to provide a favorable environment for investment, including provision of the required public goods. Even the latter could be limited to the extent that the private sector is able to invest in extension, research, basic access infrastructure and conservation and preservation facilities. Targeting of particular crops for export by the public sector is likely to be less than optimal, and perhaps even counterproductive, judging by experiences elsewhere.

### 5.3 Fishing

65. Sao Tomean waters are blessed with an abundance of fish varieties. Local fishing is, nevertheless, confined to artisanal operations. STP has an agreement with the EU, which was renewed in early 2000, under which a specified number of European industrial fishing vessels are allowed to operate in STP's exclusive deep-sea fishing waters. The fee for this privilege is US\$1.9 million.<sup>47</sup> Despite the restrictions and constraints facing local fishing, it is already an important source of protein and income. Fishing possibilities are, however, limited. The continental shelf, which permits fishing in relatively shallow waters, is narrow. Most artisanal vessels are small and unequipped with outboard motors, so that they cannot fish more than 16 kilometers from the coast. Even those that are equipped with motors must limit the time they are at sea thanks to the high cost of diesel fuel (about 50 US cents per liter). Processing, cold storage and conservation, and distribution facilities are extremely rudimentary. One of the goals of the PRSP is to increase the amount of catch to guarantee domestic food security, and some donor support to small fishermen is provided by Taiwan and Japan. This objective may be feasible; but developing a fishing industry for export to, say, the European market would appear to be a distant goal at this point, despite the potential for deep sea tuna and shellfish. As with tropical food products, the best option to investigate might be investment by established enterprises which can guarantee market access as well as possessing the know-how to comply with phyto-sanitary regulations and quality requirements.

### 5.4 Tourism

66. Tourism has undoubtedly expanded in recent years from a very low base, although statistically the situation is unclear since there is no way of distinguishing tourists *per se* from business travelers. A significant proportion of the increased arrivals are probably petroleum-related. The tourism industry is relatively underdeveloped, though a few attractive resort complexes have been constructed recently on both São Tomé and Príncipe islands. With the exception of the principal hotel in the capital city, occupation rates would appear to be below the profitability threshold. The problems hindering growth of the sector include a lack of marketing,<sup>48</sup> infrequent and relatively expensive flights, and health issues, especially the prevalence of malaria.

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<sup>47</sup> See Frynas et al., 2003

<sup>48</sup> Though there have been a few articles recently in newspaper magazine attachments, notably in France.

67. A considerable number of studies have been carried out on tourism development in STP. Building on these, the Government has already developed a strategy which was presented to a donor round table at the beginning of May, 2004. The DTIS will examine the studies and the results of the round table, but it is unlikely, *a priori*, that further in-depth work will be required in this sector (outline, section 3.4).

### 5.5 Shipping Services

68. Once STP has a deep water port, opportunities would arise to exploit its location much more effectively. Container vessels are getting larger all the time. Only very few ports in West and Central Africa have the depth to receive them. Other ports are already obliged to operate with smaller and shallower draft vessels than ship owners would prefer to use. Even those ports which have the required depth are not necessarily attractive to shipping lines as dropping off points. Particularly in the light of today's security and health concerns, crew costs for European vessels calling at continental African ports are already high enough to cause concern. Moreover, onward transshipment of dropped off containers, by either road or sea, from ports on the African continent is likely to be expensive and uncertain, particularly by road. In principle, STP is well placed to become a container drop-off point. Interest in this possibility has already been demonstrated by potential investors with links to the shipping industry. Clearly, initial investments would need to be modest, and should be left to the private sector. Careful monitoring of the market would be required to see if business interest was in fact building up, but further investigation of these possibilities would be a useful exercise in the DTIS (outline, section 3.5).

### 5.6 Services to the Oil Industry

69. The oil industry in STP is likely to be an "enclave" with very limited links to the local economy. Nonetheless, and while it would indeed be unrealistic to suppose that STP could become a major source of goods and services to the offshore oil operations, there are degrees of enclave. An extreme case, and which could serve as a warning to STP, is that of fellow Gulf of Guinea oil producer Equatorial Guinea. There, at least during the early years of oil production, all but a handful of oil company staff and executives lived not in Equatorial Guinea itself but in nearby Douala, Cameroon. The main reason for this was the lack of basic services on either Bioko island or the mainland portion of the country.<sup>49</sup>

70. There is no reason why this should necessarily be the case for STP, though Nigeria would no doubt be a rival for the provision of many services. Provided a timely and well-prepared and targeted training program is put in place,<sup>50</sup> STP could, at a minimum,

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<sup>49</sup> Health conditions are also poor. Not only is malaria prevalent, but the quality of potable water is deficient. As for medical services, it was necessary to go to Douala even for basic dental treatment.

<sup>50</sup> And that, in parallel, measures are taken to improve health conditions on the islands, measures which are necessary for development, exclusive of the needs of the oil industry.

provide oil industry employees and their families with basic services such as lodging, food and restaurant services, carpentry, masonry, auto-mechanics, plumbing, domestic electricity and the like. Currently, the availability of the necessary skills is seriously limited, and it is not clear to what extent current publicly funded training programs are targeted towards them. The DTIS will investigate this issue and identify other ways in which STP's local economy could benefit from oil industry spin-off activities (outline, section 3.6).

## **6. Macroeconomic and Poverty Impact of Trade**

71. The DTIS (outline, section 5) will evaluate the impact on the poor of an enhanced trade performance by STP. Recent research<sup>51</sup> has shown that the main channels through which the poor can be affected by trade include: (i) changes in relative prices of goods and services produced by the poor, in particular as they relate to changes in the prices of agricultural products produced for export; (ii) changes in the demand for factors of production, particularly unskilled labor, supplied by poor people; and (iii) changes in government revenues that might otherwise be diverted to reduce poverty. From the available data, including the 2001 Poverty Profile, an attempt will be made to analyze the structure of income and consumption, with a focus on those activities from which the poor derive their income and the key products they consume. Then, if data permit, a simple equilibrium model would be used to assess the impact of changes in trade-related income on public finance, real output, employment, etc. Finally, the impact of various policy and price changes on different categories of income in STP will be simulated. The model could also be used to simulate the impact of oil revenues under different assumptions concerning revenue use and management.

## **7. Overall Strategy**

72. STP is a small, poor, island economy which has not yet begun to profit from its natural and locational advantages. It has abundant rich soils, a climate favorable to smallholder agricultural production, and a strategic location vis-à-vis the African continent. The two most urgent priorities – diversifying exports of goods and services, and dealing with the dangers, as well as reaping the benefits, of the approaching oil boom – both point in the same direction: building upon the country's long term comparative advantage in agriculture. This is strong under any plausible set of external and internal prices. At the same time, therefore, it is this sector that is most vulnerable to oil-induced macroeconomic distortions, and it also this sector that is fundamental to an overall strategy for dealing with oil. The experience of other African oil producers, notably Angola and Nigeria, points to the dangers. Both countries possess a strong comparative advantage in agriculture; in both, however, agriculture has suffered so severely from oil-induced distortions that large net agricultural exports have been replaced by equally substantial net imports. It is therefore critical to adopt appropriate macroeconomic and fiscal policies.

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<sup>51</sup> Dollar and Kraay, 2001, McCulloch, 2003, Winters, 2002, and Winters, McCulloch and McKay, 2003.

73. Realistically, STP will probably not escape entirely from macroeconomic distortions. But even if there is a persistent exchange rate overvaluation, the strong underlying comparative advantage in agriculture still suggests a strategy towards lowering production costs in this sector.

74. Agriculture is also the sector which, directly or indirectly, will bring the greater part of the benefits from enhanced trade to the poor. As the PRSP and other documents make abundantly clear, raising rural living standards is fundamental to attacking poverty in STP.

75. While there is some scope for import substitution<sup>52</sup>, given the high degree of dependency on food imports, the size of the country dictates that any long term strategy of agricultural development would be based on production for export.

76. A strategy for promoting and diversifying agricultural exports would therefore be at the heart of the DTIS. This is not to deny the importance of other services (shipping, tourism, servicing the oil industry etc.), but these activities are likely to have less of an impact on poverty than agricultural development. This concept paper has identified some of the possibilities, and briefly considered the main, and formidable, constraints to be overcome before such a strategy can be expected to yield its fruits. Time is of the essence. Although oil production itself may be seven or eight years away, the first signs of financial and economic distortions – through advance payments and the like – are already manifest.

## **7. Overall Methodological Approach**

77. Many of the issues raised in this concept paper are, or have been, the subject of analyses by the Government, the World Bank and other multilateral and bilateral institutions. The DTIS will provide a comprehensive and up-to-date assessment starting with existing documents, filling any existing gaps and obtaining the latest available information. The work we will draw upon includes the ongoing studies on the port and international airport, the assessment of the impact on STP of an EPA with the EU and the related question of regional integration, other donor-sponsored exercises and the Bank's ongoing work in the areas of public sector management and the legal and judicial framework. Extensive interviews will be conducted both in STP itself and elsewhere with actual and potential economic actors, some of which have already been contacted during the identification mission.

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<sup>52</sup> There are already indications that, in the case of some food products, the small size of the domestic market presents a serious constraint to local production. Even when farmers overcome the difficulties involved in actually getting their produce to market, they find that oversupply quickly reduces prices to levels which render future production unprofitable. This has happened, for instance, in the case of tomatoes.

## **8. Country Role, Management and Team Composition**

78. The Direction of Commerce in the Ministry of Commerce, Industry and Tourism is the IF implementing agency in STP. Following the identification mission in late April/early May 2004, the Ministry had appointed the Director of Commerce as the IF Focal Person, and is in the process of forming an IF Steering Committee (IFSC), which will be presided by the Director of Commerce. The IFSC will consist of representatives of government, private sector, civil society and donors and will manage the IF process in the country. The UNDP office in São Tomé has kindly agreed to act as the local donor focus point. Upon completion of the draft DTIS, and prior to its national validation, the IFSC, with the support of the DTIS team leader, will be responsible for organizing a national workshop (plus working committees at sectoral and thematic levels if necessary) to facilitate an effective discussion and national ownership of the reforms proposed. It will then inform and coordinate with the national Authorities in the process of the official endorsement of the recommendations. The DTIS will be finalized following these discussions, and would then be endorsed by the Cabinet. The fully nationally-owned DTIS will then be presented to a round table of the international donor community.

79. The IF will work closely with the IFSC during all stages of report preparation. During the main mission, the IF Focal person will play a pivotal role in coordinating meetings and keeping abreast of the mission's activities. Provision has been made by UNDP for logistical support to the IF focal point secretariat, and this will almost certainly be needed both during the main mission and – more especially – during the preparation of the national workshop and the donor round table.

### **Team Composition**

80. The overall STP IF is managed and supervised by Ms. Nancy Benjamin (Trade Coordinator, Africa Region, World Bank). Ms. Dorsati Madani (World Bank Country Economist for São Tomé e Príncipe) will provide general support and advice as well as assuming responsibility for the section on export and investment promotion. Mr. Leendert Solleveld (Trade Department) will provide support in the dialogue with donors and the IF Steering Committee.

### ***DTIS Team Leadership (Provisional)***

Robert Lacey (consultant)  
Enrique Aldaz-Caroll (Trade Department, World Bank)

### ***Socio-Economic Policy Environment***

Macroeconomic performance and environment (including oil impact): Mr. Harnack and IMF team

Trade policies and performance: Dr. Juan Luis Moreno

Macroeconomic and poverty impact of trade: Enrique Aldaz-Caroll

International market costs and constraints: Dr. Juan Luis Moreno

Internal market costs and constraints: Richard Lacroix

Business environment:

Institutional environment: Sao Tomean consultant

Export and investment promotion (including free zones): Ms. Dorsati Madani

Other aspects of the business environment: Robert Lacey and Richard Lacroix.

### ***Sectoral Analyses***

Agriculture, agri-business and fishing: Richard Lacroix

Services (shipping, tourism): Robert Lacey

Capacity building and services to oil industry: Consultant to be identified

### ***Peer Reviewers***

### **Tentative Timetable**

Identification mission:	April 26-May 4, 2004
Circulation of draft Concept Note:	June ..., 2004
Review Meeting, Concept Note:	July..., 2004
Video/audio conference with government team:	July..., 2004
Meeting with Geneva-based agencies:	July..., 2004
Main mission:	July 26-August 12, 2004 <i>or</i> September, 2004
Submission first draft by consultants:	4 weeks after main mission
Submission final draft by consultants:	6 weeks after main mission
DTIS first draft:	8 weeks after main mission
DTIS second draft:	10 weeks after main mission
National workshop:	14 weeks after main mission
Adoption of DTIS by Government	18 weeks after main mission
Donor round table	To be determined

### **Abbreviations**

ACP	African, Caribbean and Pacific
CAS	Country Assistance Strategy
CEMAC	Communauté Économique et Monétaire de l'Afrique Centrale
DTIS	Diagnostic Trade Integration Study
EBA	Everything But Arms
ECCAS	Economic Community of Central African States
EPA	Economic Partnership Agreement
EU	European Union
GDP	Gross Domestic Product
IF	Integrated Framework
IFSC	Integrated Framework Steering Committee
IMF	International Monetary Fund
ITC	International Trade Center

JITAP	Joint Integrated Technical Assistance Program
LDC	Least Developed Country
OHADA	Organisation pour l'Harmonisation en Afrique du Droit des Affaires
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
SMP	Staff Monitored Program
STP	São Tomé e Príncipe
TAP	Transportes Aéreos Portugueses
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
USTDA	United States Trade Development Agency
WDI	World Development Indicators
WTO	World Trade Organization

## Proposed DTIS Outline

Executive Summary

Action Matrix

Introduction

1. Socio-economic context
  - 1.1 Overview
  - 1.2 Recent economic developments and prospects
2. São Tomé and Príncipe's Foreign Trade
  - 2.1 External sector performance
  - 2.2 Trade taxes
  - 2.3 Trade relations with the EU and regional integration
  - 2.4 Informal sector trading
  - 2.5 Export and investment promotion
  - 2.6 Relations with the WTO
3. Possible Sources of Export Diversification
  - 3.1 High quality traditional products
  - 3.2 Tropical food products and flowers
  - 3.3 Fisheries
  - 3.4 Tourism
  - 3.5 Shipping services
  - 3.6 Services to the oil industry
4. Constraints to Export Diversification and Competitiveness
  - 4.1 International transport costs and market access
  - 4.2 Local factor costs and services (including financial sector)
  - 4.3 Barriers to supply response
  - 4.4 The business environment
  - 4.5 Human capital
5. The Impact of Trade on Poverty and the Economy
6. Strategy and Action Program for Export Diversification

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CEMAC : « Accord de coopération commerciale entre la CEMAC et la République Démocratique de São Tomé et Príncipe. » (See also « Note d’observation du

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