Country Economic Report 2002:3

# Cape Verde:

## From Aid Dependency to Self-Sustaining Growth?

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SWEDISH INTERNATIONAL DEVELOPMENT
COOPERATION AGENCY

This country economic report on Cape Verde is part of a series of annual studies, which are undertaken by the departments of economics of three Swedish universities in collaboration with the regional departments of Sida, under an agreement with the Division for Policy and Socio-Economic Analysis. The purpose of these studies is to improve Sida's economic analysis and knowledge of the programme countries for Swedish development cooperation in order to enhance the effectiveness of programme as well as project support.

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ISBN 91-586—8554-5
ISSN 1404-031x

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# CAPE VERDE:
# FROM AID DEPENDENCY TO SELF-SUSTAINING GROWTH ?*

## 1. Introduction

A major structural and historical feature of the economy of Cape Verde is its high dependence on external assistance consisting of official development aid as well as private remittances from Cape Verdean emigrants living and working abroad. This high dependence was the main argument, put forward by the UNCTAD in 2000, for maintaining the country in the group of Least Developed Countries (LDCs), in spite of an average income per capita (some 1,300 US$) well above the threshold generally used to determine their list of LDCs.[1] A new assessment, however, is to be made by the UNCTAD in 2003 in order to determine whether the country should remain among the LDCs.

The purpose of this paper is to study the process from aid dependency to self-sustaining economic growth, and to see to what extent this process has been (and is) affected by the economic strategy and policy implemented in Cape Verde during the past decade. In order to highlight this issue the paper examines two main areas. The first is the evolution, nature and patterns of aid dependency. The second is the emergence and consolidation of a form of self-sustaining growth. In doing this we also examine critical constraints of more institutional character that slow down the transition from dependent to self-sustaining development, and discuss how to lessen these constraints.

The paper is structured as follows. The second part discusses the evolution and patterns of aid dependency in Cape Verde. Here, both official and private assistance, the latter in the form of emigrants' remittances, is examined. Next, we examine the

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* Thanks are due to Jessica Arnebäck, Jørgen Carling, Horacio Dias Fernandes, Encarnação Alves, Charlotta Norrby, Adao Rocha and seminar participants in Stockholm for constructive comments on a preliminary version of this article. Thanks are also due to Júlio Morais and Isa Morais Rodrigues for valuable assistance during my stays in Praia, and to all the officials and others in Cape Verde who devoted time to informing me about the economic and political situation.

[1] CNUCED (2000).

factors behind the rapid growth experienced by the country in the 1990s and assess its sustainability. Then we discuss two factors, fiscal fragility and foreign direct investment, both of which play a critical role in the transition from high to more self-sustaining growth. The final section summarises the main points of the paper.

## 2. Aid Dependency: Development and Patterns

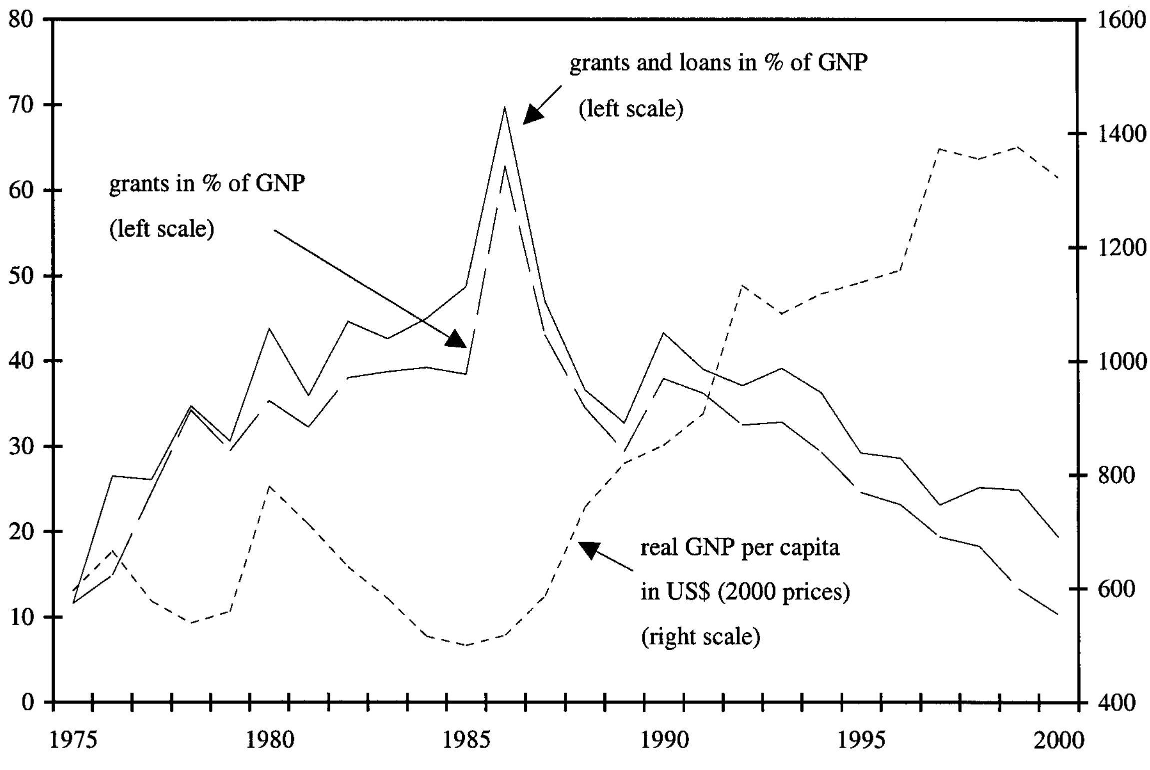
External assistance to Cape Verde takes two main forms, official development assistance and private remittances from Cape Verdean emigrants. The two forms are to some extent interrelated in the sense that increased official assistance, for example in the form of food aid programmes, diminishes the need for (and presumably the volume of) private remittances. By the same token, increased emigrants' remittances to Cape Verde lead to increased per capita income, which in turn can result in decreased official assistance because of the role of average per capita income in the donor countries' decision to grant assistance and to what amount. Other types of more dynamic interactions can be found between these two forms of external assistance.

*2.1 The rise and fall of official assistance*

Historically, adverse ecological and climatic conditions have made Cape Verde dependent upon official assistance. Prior to independence from Portugal in mid-1975, external assistance to Cape Verde took mostly the form of food aid programmes intended to limit the negative effects of droughts on food consumption and poverty. Food aid granted since the 1960s has enabled the population to survive prolonged drought without suffering famine. Independence has led to a diversification of the geographical sources of external assistance as well as a diversion of assistance away from food aid programmes towards other types of aid. A reason behind the diversion is the donor community's support to the efforts of the newly independent state in favour of economic self-sufficiency.

Figure 1 illustrates the development of official foreign assistance (in relation to GDP) to Cape Verde after independence in 1975. A striking feature of foreign assistance to Cape Verde over time is its apparent tendency to rise and then decline. Actually the past two and a half decades can be divided into three contrasting sub-periods. The first sub-period stretched from independence to 1980 and witnessed a quick rise of aid dependence with foreign assistance jumping from 10 percent to 30-40 percent of GNP. The second sub-period covered the whole of the 1980s with assistance to Cape Verde remaining at high levels and amounting to 35-45 percent of GNP.[2] The third sub-period started in 1990 and is still going on. It shows a steady and speedy decline of foreign assistance from some 40 percent to 10 percent of GNP. The decline is less pronounced if concessional loans with a grant element are included in the figures for foreign assistance (see Figure 1). This latter aspect illustrates a change in the structure of assistance to Cape Verde, with concessional loans from multilateral agencies accounting for a larger and growing share of total assistance to the country, and bilateral grants for a shrinking share.

*Figure 1:* Official assistance (in % of GNP) and real GNP per capita, 1975-2000




*Sources of Data:* OECD (2001) International Development Statistics, and for the year 2000, estimates from the *Banco de Cabo Verde* and IMF.

[2] The exceptional peak for 1986 in Figure 1 is not found in other studies of foreign assistance to Cape Verde. See e.g. Lesourd (1995), p. 408.

Another related feature of foreign assistance to Cape Verde is its rather high volatility over time. This might have contributed to macroeconomic instability because of the large role of aid in the economy. It might also have complicated the formulation and implementation of fiscal policy, because of the impact of aid on budgetary revenue, and thereby added to exchange rate variability. Yet another striking feature of Figure 1 concerns the relation between income per capita and foreign assistance. In the first decade following independence, increased foreign aid was not associated with improved real incomes, as illustrated by non-increasing real GNP per capita in Figure 1. Actually, real incomes stagnated whereas foreign aid augmented four-fold during this period. On the other hand, the rapid increase in real incomes since the mid-1980s has run parallel with a rapid reduction in foreign assistance to Cape Verde. The decline in the aid-GNP ratio during the 1990s reflects the rapid economic growth experienced by the country in this period. But it also reflects the stagnation and eventual decrease in the absolute levels of real aid flows to Cape Verde, which in turn to some extent can be related to the country's relatively high level of average income per capita that, over time, has made it less eligible for assistance from several donor countries. Table 1 shows that the decrease in real aid flows only occurred during the second half of the 1990s, and that it concerned more aid commitments than real aid flows. The decrease in aid per capita was more pronounced, with the ratio of aid to population returning, in the late 1990s, to its early 1980s level.[3]

The changes in the volume of aid to Cape Verde over time have been accompanied by significant changes in its composition. This is also illustrated in Table 1, which shows the distribution of bilateral aid among different types of aid and sectors. The most important change concerns programme assistance (that is general contributions like balance of payments, budget and structural adjustment support) that has been halved in relative terms over the past one and a half decades. Food aid, which is included in programme assistance, experienced a relative decrease of the same

[3] Aid per capita remains, however, considerably higher in Cape Verde than in other Sub-Saharan countries. In 1999, aid per capita (net ODA per capita) amounted to 318 US$ in Cape Verde while it only averaged 18 US$ in Sub-Saharan Africa (and 23 US$ when excluding South Africa and Nigeria). World Bank (2001), p. 298.

magnitude, from 41 to 20 percent of total aid. Aid to production sectors (agriculture, manufacturing, trade, banking and tourism) decreased as well but less markedly. In addition, aid to economic infrastructure and services (mostly energy, rural electrification, transportation and communications) decreased in the late 1990s, after having fluctuated widely before, reflecting the large size of the projects undertaken and their concentration to certain time periods.

*Table 1:* Volume and distribution of aid, 1975-1999 (average)

| | 1975-79 | 1980-84 | 1985-89 | 1990-94 | 1995-99 |
|---|---|---|---|---|---|
| Volume of aid (in constant 1998 US $) | | | | | |
| Actual aid (US $ million) | 56.8 | 97.4 | 120.7 | 132.4 | 128.5 |
| Aid per capita (US $) | 201 | 314 | 342 | 358 | 318 |
| Aid commitments (US $ million) | 79.2 | 127.3 | 120.3 | 139.7 | 113.4 |
| Distribution of aid in % of total bilateral ODA commitments | | | | | |
| Programme assistance | 60 | 52 | 56 | 29 | 29 |
| (of which food aid) | (41) | (34) | (30) | (20) | (20) |
| Social infrastructure & services | 8 | 7 | 5 | 21 | 33 |
| Economic infrastructure & services | 6 | 13 | 9 | 17 | 8 |
| Production sectors | 20 | 18 | 17 | 15 | 14 |
| Multisector | 2 | 3 | 8 | 9 | 1 |
| Action related to debt | 0 | 0 | 0 | 0 | 5 |
| Other | 4 | 7 | 5 | 9 | 10 |
| Total | 100 | 100 | 100 | 100 | 100 |

*Note*: Aid commitments include all grants and loans to Cape Verde undertaken by governments, official agencies and international organisations. Actual aid represents the sum of Official Development Assistance (ODA) and Other Official Flows (OOF) disbursed by the official sector at large. Aid per capita is actual aid divided by population.
*Source*: Computed from OECD (2001) International Development Statistics.

On the other hand, two types of assistance exhibited a relative augmentation. The most striking increase concerns social infrastructure and services (education, health, water supply and sanitation, etc.) that accounted for a third of total aid commitments in the late 1990s, whereas it only accounted for 5-8 percent in the 1975-1989 period. This change reflects the new priority in aid policy accorded to human capital formation and the development of human resource capabilities. Lately, a non-negligible share of foreign assistance has also been devoted to the amortisation of the internal public debt.[4] Table 1 shows that aid devoted to the amortisation of the domestic public debt represented 5 percent of total aid commitments during the second half of the 1990s.[5]

*2.2 The rise of private remittances*

Another form of aid to Cape Verde consists in the remittances from emigrant workers and members of the Cape Verdean diaspora across the globe. The diaspora comprises the successive waves of Cape Verdean emigrants and their descendants throughout history.[6] It is estimated at some 450,000 people, that is, more than the current resident population in Cape Verde, which was estimated by the Population Census to be some 435,000 in 2000.[7] Around 60 percent of the members of the diaspora are living in the United States, some 25 percent in Western Europe and the rest in coastal Africa, mainly in Angola and Senegal.[8] The history of emigration from Cape Verde is intimately related to the history of the country. It is in particular the recurring droughts and the spectre of famine that have made Cape Verdeans a nation of emigrants. Still today, more than half of the population wants to emigrate, albeit the figure varies somewhat across islands and over time. Several factors are put forward to explain the desire to emigrate: expectations of a better life, family ties, too low remuneration, hope of a new occupation, and unemployment.[9] The large size of the

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[4] In the late 1990s, foreign aid contributed to the financing of the Trust Fund, the main objective of which was to reduce the burden of domestic public debt on public finance. Another source of financing of the Trust Fund was the proceeds from the privatisation of state-owned enterprises. On the Trust Fund and its role in macroeconomic stabilisation, see e.g. IMF (2001a), p. 21, and Bourdet (2000), pp. 124-125.

[5] Note that these shifts in the allocation of aid are not specific to Cape Verde and that similar shifts can be noticed in total official assistance to other developing countries. See for example Hjertholm and White (2000), pp. 90-93.

[6] For analyses of the history of emigration from Cape Verde, its distribution across destination countries and continents, its composition by islands of origin and by gender, and its demographic consequences, see Andrade (1996), pp. 200-225, Lesourd (1995), ch. 11, and Andrade (1998).

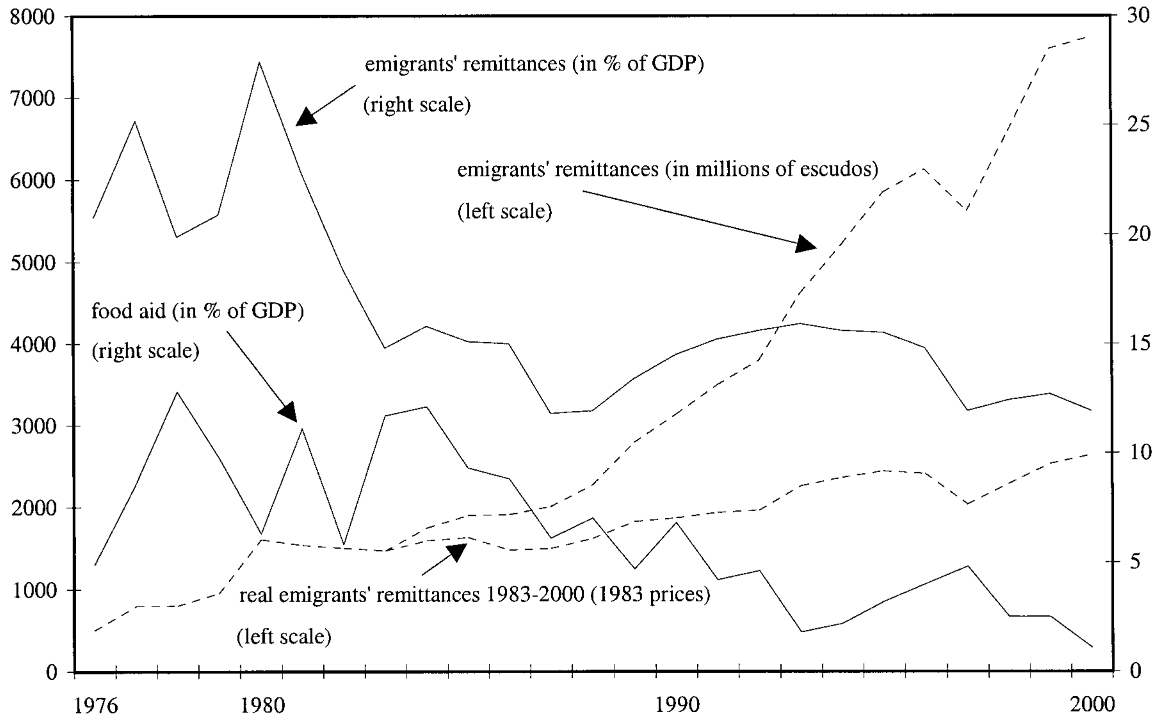
[7] A higher figure is provided by Jørgen Carling who estimates the Cape Verdean diaspora at 510,000 (Carling (2001), p. 7). See also his discussion of the definition and various estimates of the Cape Verdean diaspora in Carling (1997).

[8] In absolute figures, the Cape Verdean Diapora communities are estimated to 250,000 in the United States, 60,000 in Portugal, 40,000 in Angola, 25,000 in Senegal, 17,000 in France, 12,000 in Spain and 10,000 in both Holland and Italy (Andrade (1998), p. 78).

[9] Expectations of a better life and family ties are the reasons that are most often advanced as motives for the desire to emigrate (in around half of the answers). Labour market related factors, such as unemployment, and income and job dissatisfaction, play a less important role, which explains why the proportion of the population that wants to emigrate does not fluctuate with economic conditions and is rather stable over time. There is a gender dimension in the answers with family reasons playing a larger role for women than for men. For more details, see the quarterly publication of the institute in

Cape Verdean overseas diaspora, combined with a relatively strong motivation to remit, explains the considerable volume of remittances when related to the size of the country. In the late 1990s remittances provided three times more foreign exchange than merchandise exports (re-export of fuel included) and two and a half times more than tourism revenues. Such large figures confirm that remittances play a decisive role in the Cape Verdean economy, substantially affecting savings, real incomes, income and wealth distribution, the scope and the depth of poverty, rural-urban migration, and current and longer-term growth.[10]

*Figure 2:* Emigrants' Remittances to Cape Verde, 1976-2000.




*Sources of data:* Banco de Cabo Verde, *Instituto Nacional de Estatística (Contas Nacionais)* and for food aid OECD (2001) International Development Statistics.

Figure 2 portrays the changes in remittances in Cape Verde after independence. It makes use of official statistics on remittances collected by the central bank (Banco de

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charge of the analysis of employment and unemployment (*Instituto do Emprego e Formação Profissional*). For a statistical analysis of the individual determinants of aspiration to migrate, see Carling (2001), pp. 73-91.

[10] According to the last household survey conducted in Cape Verde (in the late 1980s), between 60 and 70 percent of the families benefit from remittances from abroad (see Banque Mondiale (1994), pp. 3-4). A new household survey is currently being undertaken, which should provide an update on the role of remittances in household incomes. The results of the survey will not be available before late 2002.

Cabo Verde). These statistics probably underestimate the real stream of remittances because they do not include the substantial amounts that are carried back on holidays in, and visits to Cape Verde, or those via various under-ground channels most often changed in parallel markets.[11] Moreover, the definition of remittances was changed in 1981, which means that any comparison of levels and trends between the period before 1981 and that after 1981 should be interpreted with caution.[12]

Bearing in mind these limitations, several findings emerge from Figure 2. A striking finding concerns the very rapid increase in the absolute level of current remittances over the past two and a half decades, in particular after the mid-1980s. The real increase in the stream of remittances is, however, much less pronounced. This is illustrated in Figure 2, which indicates that the increase in real remittances started in the late 1980s and continued steadily during the 1990s with the exception of 1997. Real remittances augmented by some 50 percent between the late 1980s and the late 1990s. Figure 2 also shows the change in the remittances to GDP ratio. First it shows a sharp decrease during the first half of the 1980s, then an increase to a peak in 1993, and finally again a decrease with the ratio back to what might be its "natural" long-term level, some 12 percent.[13] The rapid increase in current remittances in the late 1980s and early 1990s is mirrored in the remittance-GDP ratio jumping from around 12 percent in 1987 to 16 percent in 1993. It is the very rapid GDP growth associated with the lower increase in real remittances that explains the decrease in the remittance-GDP ratio during the second half of the 1990s.

A better knowledge of the motivations to remit is of critical importance for the analysis of the volume, variability over time and across persons, and future prospects of remittances in Cape Verde. It is also important in order to understand their economic impact because the motivations will determine the way remittances are used and invested. Several motives to remit are usually put forward in the economic

[11] An indication of the large amount of funds transiting outside official channels is the negligible premium for foreign exchange charged by informal street traders in Praia in spite of the, from time to time, large number of applications for (i.e. shortage of) foreign currencies in the formal banking system. On this, see e.g. Olters (1999).

[12] IMF (1996), p. 84.

[13] Several authors provide much higher figures. For example, Lobban estimated the ratio of remittances to GDP at almost 50 percent in the early 1990s, but without any indication of the source of this figure (Lobban (1995), p. 59).

literature.[14] The two most extreme are altruism and self-interest. The former refers to the care of emigrants for relatives left behind in the country of origin, whereas the latter refers to selfish motives with remittances regarded as a form of investment in the quest for future returns. The latter is broadly defined to include investments in various assets (house, land, etc.) as well as remittances aimed at securing inheritance. It can also be the case that the motive to remit has both altruistic and selfish dimensions. This is suggested by Oded Stark, who labels this motive "tempered altruism" or "enlightened self-interest".[15] Whatever the motive, the income of the remitters is crucial for the magnitude of remittances and the higher his/her income the larger the stream of remittances is likely to be. But also the income of the recipient of remittances, and shortfalls in it, will be central to the volume of remittances when pure altruism is the motive to remit: the lower the income of the recipient the larger the volume of remittances. On the other hand, and particularly for remittances motivated by self-interest, the return on investments in the country of origin of the migrant, and the difference between this return and the return in the country of emigration, will be decisive for the magnitude of remittances.

The volume of remittances to Cape Verde has increased markedly since the late 1980s, parallel with a tremendous increase in per capita income and less need for emergency assistance as illustrated by the sharp decrease in food aid (see Figure 2). This finding is apparently in conflict with purely altruistic motivations for remittances.[16] The distribution of remittances among source countries shows that the West-European countries and the United States dominate with about 60 percent and 30 percent of total remittances, respectively. The share of the United States in total remittances is lower than its share in the Cape Verdean diaspora (some 60 percent). Among other things, this reflects the fact that Cape Verdean residents in the United States are often fourth or fifth generation and that identification and social allegiance (and consequently the magnitude of remittances) tend to fade away over time. Three West-European countries, Portugal, Holland, and France, account for about half of

[14] See Stark (1995), pp. 4-6 and 89-105, and Stark (1993), pp. 236-254.
[15] Stark (1993), pp. 239-240.

total remittances to Cape Verde, while they only account for a mere 20 percent of the diaspora. Besides, Portugal accounts for a share of total remittances that is significantly lower than its share of Cape Verdean residents in Western Europe, reflecting lower per capita incomes in this country. It should be noted, however, that the share of remittances from Portugal increased from less than 10 percent in the late 1980s to 20 percent in the late 1990s, reflecting the rapid growth of real incomes in Portugal and the increased number of Cape Verdean residents in this country.[17] The evidence thus confirms that the level of real income in the source country, in interaction with the lapse of time after emigration, has an important influence on the scale of remittances.[18]

The large increase in remittances since the mid-1980s is also the result of more favourable returns provided to emigrants' savings in Cape Verde. Nominal interest rates for deposits were kept constant at 6.5 percent between independence and 1985. With relatively high inflation in the early 1980s this meant that real interest rates (interest rates minus inflation) were even clearly negative during the first half of the 1980s. During this period, emigrants' remittances seem, therefore, to have been motivated by altruistic rather than selfish motives. On the other hand, increases in interest rates after 1985 (in both nominal and real terms) and the creation of special deposit accounts for emigrants' remittances contributed greatly to the rise of remittances after the mid-1980s.[19] Some one third of total emigrants' remittances are placed in such deposit accounts, which benefit from higher deposit rates.[20] Another factor that contributed to increasing the stream of remittances is the relatively strict

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[16] A better way to test the altruistic hypothesis is to see whether lower income families receive more remittances than higher-income families, *ceteris paribus*. This requires household data on both recipient and remitter families, data that unfortunately are not available.

[17] Between 1990 and 1997, the number of Cape Verdean residents in Portugal increased by 38 percent, jumping from 28.8 to 39.8 thousands (Solimano (2001), Table A-1). This figure does not include those members of the Cape Verdean diaspora who are Portuguese nationals. Part of the increase can be ascribed to an agreement between Portugal and Cape Verde that was signed in 1997 and that allowed temporary labour migration from Cape Verde.

[18] A factor that can have influenced the rise in remittances over time is the feminisation of emigration and the fact that women usually remit a larger proportion of their earnings. On the other hand, women's wages are generally lower, which might outweigh the positive impact of feminisation on the volume of remittances.

[19] IMF (1996), pp. 84-85.

monetary policy, and the fixed exchange rate regime adopted by Cape Verde after 1982, that has contributed to limiting exchange rate risks. To a large extent the considerable increase in remittances that can be observed after the mid-1980s should therefore be ascribed to self-interest.[21]

A main conclusion that emerges from the above reasoning is that remittances to Cape Verde to a large extent are driven by self-interest but that altruistic reasons are not totally absent, as indicated by the non-negligible stream of remittances in the early 1980s. Emigrants' remittances are highly responsive to the return on savings in Cape Verde and to the levels of income in the source countries. They can therefore be regarded as being the expression of "enlightened self-interest". An implication of this is that the magnitude of remittances is unlikely to decrease in the future even in case of increases in per capita income in Cape Verde and thus less need for private assistance. Remittances will continue to grow under the conditions that the favourable financial returns granted to emigrants and the diaspora are maintained, and that the real incomes of Cape Verdean emigrants in Western Europe and the United States continue to grow.

### *2.3 External assistance and growth*

Total external assistance to Cape Verde has fluctuated markedly since independence. Official aid (when related to total output) has followed an inverted U-shape profile and had, by the late 1990s, come back to its relative level at independence (around 10 percent of total output). In the meantime emigrants' remittances have increased steadily, but have decreased somewhat when related to GDP since the mid-1990s. Adding up official aid and private remittances, the volume of external assistance to Cape Verde amounts to 20-25 percent of GDP today. This is

[20] The differentials between the residents' and emigrants' deposit rates have fluctuated over time, ranging from about 1 percentage point for more than one year deposits to around 3 percentage points for shorter-term deposits.

[21] IMF performed an econometric study of the determinants of emigrants' remittances in Cape Verde between the late 1970s and 1995. The study shows that income disparities between Cape Verde and source countries, the introduction of special deposit accounts, and exchange rate anticipations had a significant impact on the stream of remittances. On the other hand, the study shows that the real interest-rate differential did not affect the stream of remittances. A reason behind the latter result may be that the dummy variable that captures the impact of the special deposit accounts on remittances also captures the impact of higher interest rate policies in Cape Verde on remittances. The study also shows a highly significant intercept that can be interpreted as a parameter reflecting altruism, constant across countries and over time. IMF (1996), pp. 84-97.

much lower than the level attained during the 1980s when external assistance accounted for more than 50 percent of GDP. The impact of external assistance on economic growth has presumably diminished as well, since the contribution of aid to growth depends, *inter alia*, on its size.

At the same time the composition of both official assistance and private remittances has changed profoundly over time so that the relation between aid and growth has been affected. The new mixes are more growth-promoting than the old. For example, the smaller role given to food aid in official assistance and the greater emphasis put on human capital accumulation and economic infrastructure signify that the same amount of aid has a higher return in terms of current and future growth now than it had during the second half of the 1970s. The reason for this is that food aid is meant for consumption while aid devoted to human capital formation and economic infrastructure is intended to build up productive capacity, to increase investments and subsequently to raise growth. By the same token the larger role seemingly occupied by self-interest in emigrants' remittances since the mid-1980s means that remittances have eased the savings constraint, supplemented national savings and subsequently increased domestic investments. A condition for the latter is of course that the banking system and overall economic policy in Cape Verde have succeeded in transforming the increased savings into productive and growth-promoting investments.

## 3. Reform Policy and Growth

In the late 1980s Cape Verde engaged in an ambitious programme of reforms, the main purpose of which was to achieve a higher rate of economic growth and to improve the standard of living of the population. The programme was initiated by the PAICV (*Partido Africano da Independencia de Cabo Verde*), a socialist party that monopolised political power after independence. Reform policy received a new and extensive impulse from the political changes that stemmed from the first multiparty legislative and presidential elections of 1991 and the victory of a new political party, the MpD (*Movimento para Democracia*), with a stronger commitment to market economy. The reform policy implemented in Cape Verde during the past decade encompasses a variety of measures of both systemic and macroeconomic nature that can summarised under three main headings.[22]

First, reform policy consists of microeconomic measures that aim at improving the allocation of production resources and at boosting current and longer-term economic growth. The kinds of measures grouped under this heading include the removal of the great majority of price controls, the privatisation of most state-owned enterprises and banks, a panoply of measures designed to encourage the expansion of the private sector and the creation and development of small and medium-sized enterprises, the strengthening of property rights in agriculture, a liberalisation (albeit limited) of the labour legislation and a modernisation of the business legislation. Taken together these measures have contributed to a transformation of the socialist inspired economic system, that was put in place in Cape Verde after independence, into a market-oriented economic system. Critical steps have been the greater scope given to markets, competition in the allocation of production resources and in the distribution of income, private ownership and material incentives to guide the behaviour of economic agents (firms and individuals). Some of the systemic measures included in the programme have only been imperfectly and partially implemented (like the privatisation of state-owned enterprises) and there remains a non-negligible number of regulations and administrative barriers that limit competition in product and factor markets.

Second, reform policy consists of measures aimed at integrating the Cape Verdean economy into the world economy. Two main components are the opening up of the economy to import competition and the promotion and diversification of exports. The removal of quantitative restrictions on imports, the simplification and lowering of import tariffs and the suppression of the monopoly of EMPA (*Empresa Pública de Abastecimento*) on food imports are examples of measures introduced to encourage import competition. Import liberalisation has not been fully credible, however. Import tariffs are still relatively high, 25 percent on average.[23] Administrative import barriers are still in place and in the mid-1990s import controls

[22] For a more detailed presentation of the reform programme, see e.g. Bourdet (2000), pp. 122-128, and Bourdet (2001), pp. 110-114.
[23] IMF (2001a), p. 12.

were re-imposed temporarily on a certain number of products. The creation of export processing zones and the promotion of foreign direct investments through tax exemptions and other benefits are intended to boost exports and favour export diversification. Both kinds of measures are expected to speed up and ease the integration of the Cape Verdean economy into the world economy, and to encourage a specialisation of the Cape Verdean economy according to its comparative advantages (in sectors like tourism, footwear and textile). Contrary to many West-African countries, Cape Verde has prioritised multilateral rather than regional liberalisation. In some measure this policy choice can be ascribed to the structure of foreign trade of the country, which is strongly biased in favour of industrial countries, in particular European countries. The adoption of a nominal exchange rate peg - first to a currency basket, after July 1998 to the Portuguese escudo and indirectly to the euro, and since January 2002 directly to the euro – has also contributed, by diminishing exchange rate variability and risks, to the economic and financial integration of the Cape Verdean economy into the international economy.

Thirdly reform policy has been accompanied by a reform of fiscal and monetary policies so as to give the government the tools necessary to pursue a macroeconomic stabilisation policy. The larger role given to markets in the allocation of resources and in the distribution of incomes by overall reform policy means that the principal economic role of today's public policy is the adoption of a stabilisation policy. Several measures have been introduced to secure this role. Fiscal and monetary policies have been separated through the setting up of a two-tier banking system with an autonomous central bank capable of conducting an effective monetary policy and supervising the operations of the commercial banks. The adoption of a nominal exchange rate peg has strengthened monetary discipline by putting strict limits on fiscal policy and monetary financing of public expenditure. The tax system was reformed several times during the 1990s (simplification of the tax structure, unification of the income tax and the tax on business profits, etc.) so as to broaden the tax base. On the expenditure side, the reform of fiscal policy consisted in an improved monitoring of budgetary expenditures and a diminution in the number of civil servants. In all these areas, however, reform policy has not been fully credible. Monetary financing of part of the budget deficit has occurred from time to time, suggesting that the separation between fiscal and monetary policies is imperfect and the independence of the central bank limited. To add to this, reform of the tax system has been proceeding relatively slowly and the planned introduction of a value added tax has been delayed. Finally, budgetary expenditures and the number of civil servants increased during the 1990s. To a large extent, the difficulties met in improving the macroeconomic stance can be ascribed to the emergence of political cycles in Cape Verde, following the introduction of multiparty democracy. Political cycles consisted in the government "losing control" over budgetary expenditures during electoral periods and subsequently calling for the central bank to accommodate the budget financing needs.

### *3.1 High growth experience 1992-*

The main objective of the whole reform policy is to achieve a higher growth rate over a longer period so as to increase substantially the real incomes and standards of living of the people. Economic growth in Cape Verde accelerated markedly during the 1990s, from 3.5 percent between 1986 and 1991 to 6.3 percent between 1992 and 2000. The country's GDP growth achievement is remarkable when placed in a cross-country perspective. This is illustrated in Table 2, which compares the growth performance of Cape Verde after 1992 with all the sustained and rapid growth experiences in Sub-Saharan Africa during the past four decades.

The growth performance of Cape Verde during the past decade seems remarkable for three reasons. First, the country experienced sustained rapid growth during the 1990s, a period in which such growth episodes in Sub-Saharan Africa were relatively rare. According to Table 2 only four other Sub-Saharan countries have experienced sustained rapid growth during the last one and a half decades. Secondly, the average rate of GDP growth in Cape Verde is of the same order of magnitude as that of strong growth performers like Uganda and Mozambique and higher than that of Mauritius and Ghana. (Note, however, that the length of the growth experience in Cape Verde is shorter). Third, growth in Cape Verde is not based on natural and primary resource endowment and favourable evolution of terms of trade. This contrasts with many of the Sub-Saharan growth episodes, which can be ascribed to natural and primary resource endowment and/or temporary increases in world market prices (illustrative examples are Botswana, Kenya, Gabon, Malawi, Côte d'Ivoire or Namibia).

*Table 2:* Sustained Growth Experiences in Sub-Saharan Africa, 1960-2000.

| Country | Start | End | Length | Average growth rate | GNP per capita (in US$; 1999) | Human development index (ranking in 1999; out of 162 countries) |
|---|---|---|---|---|---|---|
| Cape Verde | 1992 | - | $\geq 9$ | 6.3 | 1,330 | 91 |
| Ethiopia | 1960 | 1972 | 12 | 4.5 | 100 | 158 |
| South Africa | 1960 | 1974 | 14 | 5.1 | 3,170 | 94 |
| Tanzania | 1961 | 1975 | 14 | 5.7 | 260 | 140 |
| Togo | 1960 | 1974 | 14 | 6.8 | 310 | 128 |
| Côte d'Ivoire | 1960 | 1978 | 18 | 9.5 | 710 | 144 |
| Namibia | 1961 | 1979 | 18 | 6.4 | 1,890 | 111 |
| Kenya | 1961 | 1981 | 20 | 6.7 | 360 | 123 |
| Malawi | 1964 | 1979 | 15 | 6.6 | 180 | 151 |
| Gabon | 1965 | 1976 | 11 | 13.1 | 3,300 | 109 |
| Botswana | 1965 | - | $\geq 35$ | 9.0 | 3,240 | 114 |
| Cameroon | 1967 | 1986 | 19 | 7.0 | 600 | 125 |
| Lesotho | 1970 | 1982 | 12 | 9.9 | 550 | 120 |
| Mauritius | 1980 | - | $\geq 20$ | 5.4 | 3,550 | 63 |
| Ghana | 1983 | - | $\geq 17$ | 4.6 | 390 | 119 |
| Mozambique | 1986 | - | $\geq 14$ | 6.8 | 220 | 157 |
| Uganda | 1986 | - | $\geq 12$ | 6.1 | 320 | 141 |

*Note:* A sustained growth experience is defined as an uninterrupted period of 10 years or more during which the five-year moving average GDP growth exceeds 3.5 percent (Berthélemy and Söderling (2001), p. 324).
*Sources:* Berthélemy and Söderling (2001); Subramanian and Roy (2001); GDP statistics 1999-2000: World Bank; Human development index: Human Development Report 2001; GNP per capita: African Development Indicators 2001; Statistics for Cape Verde: *Instituto Nacional de Estatística.*

Another striking finding in Table 2 is the very high ranking of Cape Verde in terms of the human development index (HDI). In addition to income per capita (in purchasing power parity) the HDI takes into account life expectancy and educational attainment.[24] The good HDI performance of Cape Verde, in particular when compared to countries with higher GNP per capita such as Botswana, Gabon, Namibia or South Africa, is due to the relatively good achievements of the country in terms of human capital accumulation.

[24] For a presentation and discussion of the human development index, see UNDP (2001), pp. 13-15.

*3.2 Decomposing growth*

The rapid and sustained episode of economic growth in Cape Verde has resulted in a significant increase in the standard of living, as measured by GDP per capita. Table 3 shows that GDP per capita increased by 3.9 percent on average, reflecting an average rate of population growth of 2.4 percent during the period examined. The increase was of greater magnitude during the second half of the 1990s, some 4.5 percent, owing to more rapid GDP growth during this period. Moving from output per capita to output per worker allows better highlighting of the determinants of productivity and labour incomes. Table 3 shows that the growth of output per worker was lower than that of output per capita, 3.2 and 3.9 percent, respectively. This discrepancy can be ascribed to rising rates of labour force participation in Cape Verde over time, a pattern that is more pronounced for women than for men. Increased labour force participation has run parallel with a rapid and significant reallocation of employment away from the primary and secondary sectors towards the tertiary sector.[25] Another noteworthy finding in Table 3 is that output per worker increased slightly during the 1990s.

To improve the understanding of the dynamic of, and prospects for, growth in Cape Verde, it is necessary to single out the factors behind the growth of output per worker, namely changes in the capital stock available for each worker (capital deepening) and changes in total factor productivity (capital and labour).[26] Total factor productivity measures the output produced by given amounts of capital and labour together. Improved total factor productivity refers therefore to increased output produced by given amounts of capital and labour. It is generally the product of technological advance, better use of production resources within firms (the so-called X-efficiency) or enhanced research and development efforts. It can also be the product of structural changes and the shift of labour and capital from low-productivity to higher-productivity sectors. Table 3 shows that some two thirds of the growth of

[25] According to the 2000 Population Census, the primary, secondary and tertiary sectors accounted for 24, 19 and 57 percent of total employment in 2000, while they accounted for 31, 30 and 40 percent in 1990 (World Bank (2000), p. 270).
[26] On the virtues and limits of this "source-of-growth" approach, see Agénor and Montiel (1999), pp. 673-678, and Easterly (2001), chapter 3.

output per worker in Cape Verde can be ascribed to increased availability of capital per worker, and that one third can be ascribed to improved total factor productivity. (The estimates should be interpreted with care because of the difficulties met in estimating the capital stock.) The table also shows that there are some changes over time, with total factor productivity contributing a larger share and capital accumulation a smaller share of the growth of output per worker in the second half of the 1990s. All in all, once factor accumulation (labour and capital) is taken into account, there is thus little left in the growth episode in Cape Verde that can be ascribed to productivity growth, in particular in the first half of the 1990s.

*Table 3:* Sources of growth in Cape Verde.

| Period | Average growth rates (%) | | | Contribution to GDP-per-worker growth (%) | |
|---|---|---|---|---|---|
| | GDP | GDP per capita | GDP per worker | Capital / labor ratio | Total factor productivity |
| 1992-2000 | 6.3 | 3.9 | 3.2 | 64 (70) | 36 (30) |
| 1992-1996 | 5.6 | 3.4 | 3.0 | 72 (81) | 28 (19) |
| 1997-2000 | 7.1 | 4.5 | 3.5 | 56 (58) | 44 (42) |

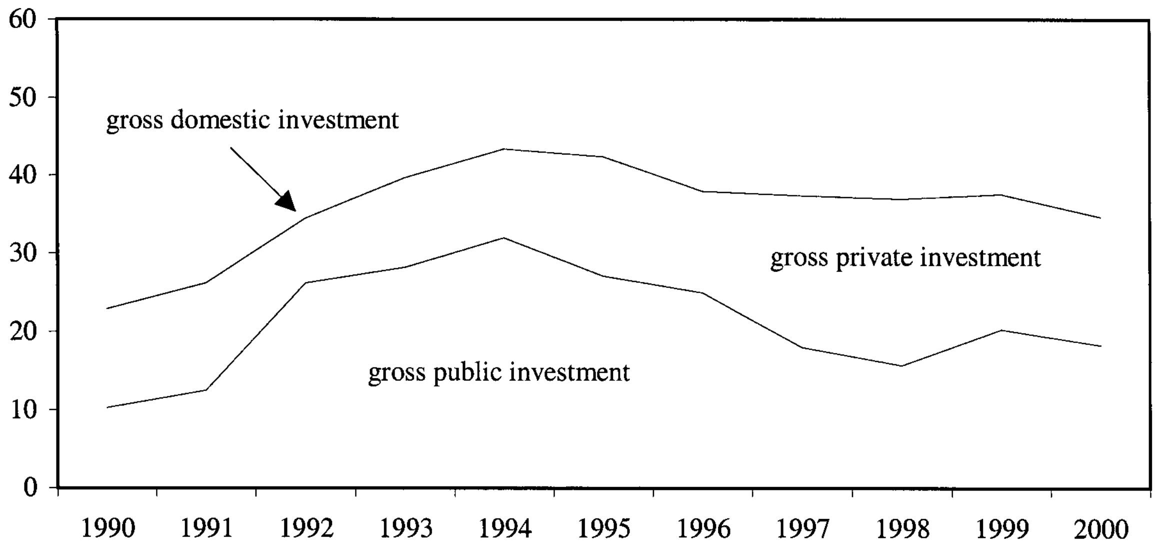
*Notes:* The contribution of the growth of capital per worker to output growth per worker is equal to the growth rates of the capital stock times the share of capital in production (estimated to one third). Cumulative investment flows for 14 years (1978-1991) using a 6 percent depreciation rate are used to estimate a benchmark capital stock in 1991. The average growth of investment flows between 1985 and 1991, as estimated in national accounts, are used to approximate the evolution of investment flows during the 1978-1984 period. An alternative method is to use the deflated investment flows (gross domestic investment) for 1978-1984 provided by the African Development Bank, completed by the investment flows (1985-1991) estimated in national accounts, to calculate a benchmark capital stock in 1991. The estimates obtained with this second method are given within parentheses.
*Sources of data:* National accounts: *Instituto Nacional de Estatística*; Selected Statistics on African Countries: African Development Bank.

Figure 3 illustrates the extraordinary rise in the investment to GDP ratio in Cape Verde during the 1990s. The increase was much more pronounced than that noticed in other Sub-Saharan countries during the same period.[27] Public investment contributed most to capital formation during the first half of the 1990s. Eventually, public investment (as a share of GDP) declined substantially during the second half of the

[27] Between 1990 and 1999, the investment to GDP ratio in Sub-Saharan Africa increased from some 14 to some 19 percent while that of Cape Verde jumped from some 23 to some 38 percent (World Bank (2001), p. 22).

1990s while private investment increased significantly. Today private investment is larger than public investment. An implication of this is that the increase in capital stock (and in capital per worker) as well as in output per worker during the first half of the 1990s can, to a large extent, be ascribed to the rise of public investment.

*Figure 3:* Investment in Cape Verde (in % of GDP), 1990-2000.




*Source:* African Development Indicators (World Bank)

On the other hand, the prolonged increase of output per worker during the second half of the 1990s can be largely attributed to the rise of private investment. Foreign direct investment (FDI) contributed significantly to the increase in private investment in Cape Verde during the second half of the 1990s.[28] A conclusion that can be drawn from this reasoning is that the changed contribution of capital accumulation versus total factor productivity gains in the growth of output per worker in Cape Verde during the second half of the 1990s (see Table 3) was due to the larger role of private investment, not least from foreign firms. The level of total investment (as a share of GDP) decreased, while aggregate GDP and GDP per worker increased, during the second half of the 1990s (see Table 3). This suggests that the efficiency of investment improved during this period and also that private investment had a stronger effect on growth than public investment. A reason might be that private capital investment, more than public investment, is directed towards activities characterised by higher value-added, higher productivity and higher rate of return.

*3.3 Sustainable growth?*

A crucial explanation of the 1990s' rapid growth episode in Cape Verde is the country's successful expansion of employment and investment. An issue that can be raised is whether this more rapid growth will continue (that is whether growth is sustainable), and whether the country will thus experience prolonged increases in GDP per capita and living standards. To be sustainable, growth needs to be the result of a balanced mix of productivity gains and capital accumulation.[29] High and increasing total factor productivity is necessary to create strong incentives for people and firms to invest in both human and physical capital. In turn, productivity gains cannot be maintained and amplified without investments in machines and equipment as well as in education and training. An implication of this is that growth is not sustainable if only (or mostly) based on capital accumulation. Neither is growth sustainable in the absence of investments (and savings).

In order to shed some light on the sustainability of the 1990s' growth episode in Cape Verde, Table 4 compares some dimensions and the sources of growth in this country with those of two other groups of countries that have experienced strong growth episodes. The first group, failed takeoffs, consists of Sub-Saharan countries, which experienced a prolonged period of rapid growth, but where rapid growth subsequently ceased. The second group of countries, sustained performers, consists of Sub-Saharan countries, which experienced a prolonged period of growth and where growth has been maintained. High growth was not sustainable in the former, whereas it was in the latter.

A conspicuous finding of Table 4 is the larger reduction in growth rates in Cape Verde, as compared to the two other groups of countries, when moving from measures of total GDP to output per worker. Larger increases in labour force participation rates

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[28] The stock of foreign direct investment (FDI) in Cape Verde as a percentage of GDP increased from 1.3 percent in 1990 to 9 percent in 1995 and as much as 21.1 percent in 1998 (United Nations (2000), p. 321).

[29] For a more complete discussion, see e.g. Young (1994), Berthélemy and Söderling (2001) and Easterly (2001), pp. 66-68.

in Cape Verde explain this difference. An implication of this is that the growth of output per worker in Cape Verde was more than one percentage point lower than in the other countries selected during their high-growth experiences. The probable slowing down of the process of intersectoral reallocation of labour (from agriculture to the other sectors) and of the increase in labour force participation rates in Cape Verde will reduce the gap between output per capita and output per worker, but it will also bring down aggregate GDP growth.

*Table 4:* Cape Verde's growth (1992-2000) in Sub-Saharan perspective.

| Country | Average growth rates (%) | | | Contribution to GDP-per-worker growth (%) | |
|---|---|---|---|---|---|
| | GDP | Labour | GDP per worker | Capital / labor ratio | Total factor productivity |
| Cape Verde | 6.3 | 3.3 | 3.2 | 64 | 36 |
| Failed takeoffs [a] | 7.0 | 2.7 | 4.3 | 62 | 38 |
| Sustained performers [b] | 6.7 | 2.5 | 4.2 | 13 | 87 |

*Notes:* a) Failed takeoffs consist of Cameroon, Côte d'Ivoire, Kenya, Malawi and South Africa. b) Sustained performers consist of Botswana, Ghana, Mauritius, Mozambique and Uganda. For the growth episode periods, see Table 2.
*Sources of data:* Table 2 and computed from Berthélemy and Söderling (2001), Tables 3.

Another striking finding in Table 4 concerns the relative contribution of capital accumulation and productivity gains in Cape Verde as compared with the two other groups of countries. Like the countries that belong to the group of failed takeoffs, Cape Verde's rapid growth is more the result of capital accumulation than of productivity gains, but the distribution is still more biased in favour of capital accumulation in Cape Verde than for failed takeoffs. On the contrary, sustained performers exhibit a distribution between capital accumulation and productivity gains that is clearly in favour of the latter (see Table 4). Comparing the growth episode of Cape Verde during the 1990s with growth episodes elsewhere in Sub-Saharan Africa clearly suggests, therefore, that the rapid growth that the country experienced during the 1990s is not sustainable.

## 4. Raising Productivity and Growth

The finding that the 1990's rapid growth was not sustainable has implications for policy formulation in Cape Verde, if the objective of economic policy, and of policymakers, is to boost total factor productivity and to put the country on a more durable, rapid growth path. First, it is necessary to revisit reform policy so as to find out the policy areas where reforms (as yet?) have not produced the expected effects. This may be due to inappropriate design of the measures included in the reform programme, but also to a deficient implementation of well-designed measures. An example of the latter concerns the postponed privatisation of some enterprises, like the airline company, TACV (*Transportes Aéros de Cabo Verde*) or the food import and distribution company, EMPA (*Empresa Pública de Abastecimento*).[30] Second, it is necessary to identify the factors and obstacles that discourage private investment and to eliminate (or at least to reduce) the distortions and institutional deficiencies that lower the efficiency of both capital and labour.

As suggested above, reform policy in Cape Verde contains measures that can be grouped under three main overlapping headings: measures of microeconomic character aimed at improving resource allocation, measures aimed at integrating the Cape Verde economy into the international economy and measures included in the macroeconomic policy stance. A thorough analysis of all these measures is beyond the scope of this paper. However, it is important for reform policy to put greater emphasis on measures that are generally recognised as affecting longer-term growth and productivity, like investment in human capital, improved investment climate, and increased trade openness and export diversification. Two issues are worth further scrutiny because of their critical role in Cape Verde: first, the emergence of political cycles in fiscal policy and their negative impact on private investment and, second, policies towards foreign direct investments.

[30] The government led by the PAICV intends to liquidate EMPA and to make TACV ready for privatisation in 2002.

*4.1 Disciplining fiscal policy*

Political business cycles refer to the attempts by governments in place (incumbents) to affect the outcome of elections through the manipulation of fiscal policy. The economic literature on elections-induced economic cycles is mainly concerned with developed countries. However, the democratisation of many developing countries has made the issue relevant for these countries as well.[31] A main result of research pertaining to developing countries is that incumbents wishing to augment their chances of re-election prefer increased public spending to tax cuts and capital expenditures to current expenditures.[32] The reason behind these choices is that they are easier to put into practice and to interrupt, and they do not imply a commitment that might be difficult to reverse once the election is over. Another result of recent research is that fiscal policy cycles are more likely to occur under a fixed exchange rate regime than under a flexible exchange rate regime, because expansive fiscal policy in the latter case leads to exchange rate depreciation and subsequently a loss of popularity.[33] Note that empirical research provides evidence of fiscal political cycles under a fixed exchange rate regime only in cases of sufficient foreign exchange reserves.[34]

Political budget cycles often lead to monetary financing of public deficits because of the difficulties encountered in increasing tax and non-tax revenue in the short run and the limited borrowing opportunities. The latter applies particularly to developing countries with low saving rates. Another factor that may contribute to the monetary financing of the budget deficit and to monetary instability is the fact that central banks are dependent on the executive power in the great majority of developing countries. The emergence of fiscal budget cycles in developing countries has a negative impact on longer-term growth (and productivity) through three main channels. First, increased public deficits and public borrowings reduce the volume of credits available for the private sector and crowd out private investment. Second, the

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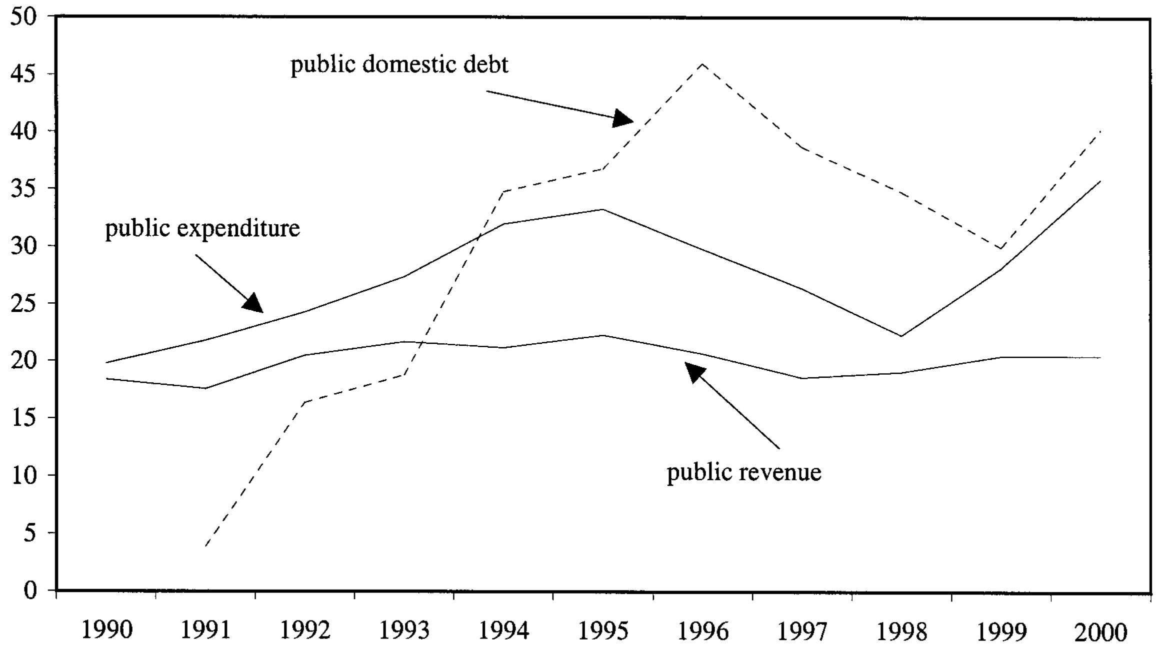
[31] For a survey of the existing literature, see Agénor (1999), pp. 752-760. Note that Agénor suggests that incumbents do not manipulate public spending systematically but only when the outcome of elections is uncertain (ibid., p. 759).
[32] Schuknecht (2000).
[33] Schuknecht (1999).
[34] Ibid

monetary financing of public deficits fuels inflation, which blurs private investment decisions. Third, rapidly rising public debt increases the risks of higher taxes in the future, which may have a deterring effect on private investment by lowering the expected rates of return on capital.

*Figure 4:* Public domestic revenue, expenditure and debt, 1990-2000 (in % of GDP)




*Note:* Public expenditure exclusive of foreign financed capital expenditure. Public revenue exclusive of external grants. Public domestic debt for 1999 and 2000 includes claims on Trust Fund (TCMFs).
*Source of data:* Public expenditure, revenue and debt: IMF (1995), (1998) and (2001b). GDP: National accounts for 1990-1995: *Instituto Nacional de Estatística*, and IMF (2001b) for 1996-2000.

Figure 4 illustrates the existence of a political budget cycle in Cape Verde during the last decade. Here, public expenditure and revenue are exclusive of foreign-financed public expenditure and foreign grants in order to better capture the domestic political determinants of fiscal policy. The first multiparty elections (parliamentary and presidential) after independence were held in 1991 and won by the MpD (*Movimento para Democracia*) that remained in power for one decade. Apart from the first democratic elections of 1991, the country went through four national elections (two parliamentary and two presidential) concentrated to two electoral periods, the first period covered late 1995 and early 1996 and the second early 2001. Figure 4 shows that government spending increased significantly prior to these two electoral periods, during the electoral campaigns in 1994-1995 and in 1999-2000.[35] On the other hand, public revenue (that is tax and non-tax revenue) changed marginally during the periods considered, suggesting that increased expenditure, rather than tax cuts, was the instrument used by the government to spur its popularity before elections and to attempt to influence election outcomes.

However, the kinds of expenditure, preferred by the government, to generate political support changed between the two electoral periods. In 1994-1995, the government made use of increased capital expenditure to enhance its popularity, whereas, in 1999-2000, it employed increased transfers and subsidies, in particular petroleum-price subsidies and scholarships for students abroad.[36] The expansion of public spending during the latter period also reflected the financing of a large-scale public work programme aimed at alleviating the impact on poverty of the drought, and various restructuring costs in relation to the privatisation of state-owned enterprises.[37] The upsurges of public expenditures during both electoral periods led to a rapid increase of the domestic public debt, which jumped from less than 5 percent of GDP in 1991 to 40 percent of GDP in 2000.[38] The commercial banks and other financial institutions held the lion's share of the public debt. Increased public expenditure has thus crowded out private investment and hence adversely affected productivity growth. In addition, increased public expenditure, devoted to transfers and domestic debt payment, has crowded out public expenditure on infrastructure and human capital, endangering an important element of longer-term growth.

Disciplining fiscal policy and containing political cycles within certain limits should be a first priority for economic policy in Cape Verde. It is necessary for reducing the risks of unsustainable fiscal imbalances and for sustaining longer-term growth and productivity. It is also necessary for securing the fixed exchange rate

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[35] Figure 4 underestimates the increase in government spending in 2000 because it does not take into consideration the rapid accumulation of domestic and external arrears. On the volume of arrears in 2000, see IMF (2001a), p. 18.

[36] Starting in 2000, the government replaced the old scholarship system of bank loans for students with a new one of grants directly paid out of the budget.

[37] The shift in public expenditure noticed in Cape Verde during the second electoral period confirms recent research showing that political budget cycles in developing countries affect the composition of public spending away from public investment and towards current consumption (see Block (2001)).

[38] Part of the increase in the domestic public debt during the first half of the 1990s can be ascribed to the central bank taking over loans to state-owned enterprises in relation to their privatisation.

between the c.v. escudo and the euro. The 1998 exchange rate arrangement between Cape Verde and Portugal contained, among others things, the *obligation* for the government of Cape Verde to comply with the Maastricht criteria, that is a government deficit below 3 percent of GDP, a debt-GDP ratio below 60 percent or declining at a satisfactory rate, a long-term interest rate at most 2 percent above that of the three best performing countries in terms of inflation, and an inflation rate at most 1.5 percent above that of the three best performing countries. Obviously, Cape Verde did not comply with all of these criteria. Several reasons can be advanced to explain this failure. A first is the absence of a real bilateral surveillance mechanism, the exchange rate arrangement being regarded by policymakers in Cape Verde as a unilateral peg.[39] A second is the absence of a domestic political commitment to, and a social and political consensus on, the virtues of fiscal restraints as expressed by the criteria. A third is the absence of a real, independent central bank having price stability as the sole objective. A fourth reason is that the Maastricht criteria are designed for industrial countries and badly adapted to the economy of Cape Verde.

The analysis of the reasons behind fiscal instability in Cape Verde suggests that a reform of the fiscal stance should contain three main institutional components: a stronger commitment to fiscal discipline (and if possible a consensus between the main political parties), an independent central bank and a mechanism of international surveillance. In its long-term strategy, the newly elected government emphasises the role of greater fiscal discipline (stronger commitment) and of an autonomous central bank in achieving macroeconomic stability.[40] These are steps in the right direction but hardly sufficient to achieve fiscal credibility. The political commitment is fragile since it is not supported by a consensus between the two main parties (the PAICV and the MpD). Then the strategic programme only speaks of an autonomous central bank, not of an independent one. Under the pressure from the IMF the government has gone further and approved in February 2002 a new central bank law that ensures the central

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[39] The exchange rate arrangement contains a line of credit made available by the government of Portugal to secure the convertibility of the c.v. escudo. Mutual consent is required for drawings from it. The credit line was suspended in 2000 following Portuguese concerns over the conduct of fiscal policy in Cape Verde. This suspension was short-lived and in 2001 Portugal made a new line of credit available in support of the exchange rate peg.

[40] República de Cabo Verde (2001), p. 25.

bank independence from the government.[41] And last but not least, there is no mechanism of international (bilateral or multilateral) surveillance with fiscal rules tailored to the country.

*Table 5:* Cape Verde's Compliance with the WAEMU's Convergence Criteria

| | Compliance in 2000 |
|---|---|
| Primary criteria | |
| - ratio of the basic fiscal balance to nominal GDP (key criterion): 0 % or more | no |
| - average annual inflation rate: 3 % or less | yes |
| - ratio of outstanding domestic and foreign debt to nominal GDP: 70 % or less | yes |
| - unchanged or decreasing domestic and external arrears | no |
| Secondary criteria | |
| - ratio of the public wage bill to tax revenue: 35 % or less | no |
| - ratio of domestically financed public investment to tax revenue: 20 % or more | no |
| - ratio of the current external deficit excluding grants to nominal GDP: 5 % or less | no |
| - ratio of tax to GDP: 17 % or more | yes |

*Note:* The basic fiscal balance, called the key criterion, is equal to total revenue minus total expenditure excluding grants and foreign financed investment.

An international surveillance mechanism with clear fiscal rules is the best way to secure fiscal credibility and to support the exchange rate peg.[42] Such a surveillance system could be part of the exchange rate agreement between Portugal and Cape Verde. It should contain fiscal rules that fit the characteristics of the Cape Verdean economy and its development problems. A source of inspiration can be the convergence criteria of the Western African Economic and Monetary Union (WAEMU) that have been designed to secure the fixed exchange rate system between the CFA-franc and the euro, and to promote the economic development of the member countries. Applying the WAEMU convergence criteria to Cape Verde confirms that the country's fiscal performance is poor and the fiscal situation fragile (see Table 5). In 2000, the country only satisfied three out of the eight criteria: those concerned with inflation, total public debt and tax revenue. Worth noting is that the country did not satisfy the inflation criterion in 1998-1999, that the public debt (67.2 % of GDP) is

[41] IMF (2002), p. 8. The new law, that is to become effective at the end of June 2002, has price stability as the overriding objective. Whether (and when) the new law will free the central bank in Cape Verde from political interference remains difficult to foresee since a high degree of central bank independence depends *inter alia* on underlying public attitudes, which only change in the longer run.
[42] For an illustration with special reference to West Africa, see Masson and Pattillo (2001a).

very close to the criteria level, and that the relatively high ratio of tax revenue to GDP (18 %) is largely due to import tariff revenue (half of total tax revenue), which is to shrink in the aftermath of trade liberalisation. Undoubtedly, the introduction of an international surveillance system will clearly improve fiscal credibility in Cape Verde. In addition, it will make it easier to join the monetary union that is planned by the members of the Economic Community of West African States (ECOWAS) if the country decides to join.[43] In this case, regional surveillance will replace bilateral surveillance with roughly similar fiscal rules.

*4.2 Maximising the productivity and growth effects of FDI*

A main finding of the above analysis of the sources of growth in Cape Verde in the second half of the 1990s concerns the vital role of private investment in the growth of GDP per worker and total factor productivity. The rise of private investment in the country was partly reflected by the expansion of small-sized private enterprises.[44] In 1997, 89 percent of the total number of enterprises in Cape Verde employed between one and five persons and an additional 9 percent six to twenty 20 persons. The small size of the bulk of the private enterprises implies that their contribution to private investment and capital accumulation is limited. This applies particularly to all the small enterprises in the service sector (food retailing, catering, etc.), that are labour intensive. Only 20 percent of the small private enterprises belong to the industry sector (construction and, to a lesser amount, manufacturing). The distribution of investment across sectors mirrors these patterns with some two thirds of total investment being concentrated to construction and only a fifth being devoted to equipment. All this suggests that the increase in private investment in Cape Verde can, to a significant extent, be ascribed the rise of foreign direct investment.

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[43] In April 2000, six of the seven non-CFA members of ECOWAS expressed their intention (the Accra Declaration) to establish a second monetary union in West Africa by 2003 and to work towards the creation of a unified monetary union, including both CFA and non-CFA countries by 2004. Cape Verde was the only non-CFA ECOWAS member not to sign the Accra Declaration. The new government led by the PAICV is more committed to regional integration and to co-operation with Western African States than its predecessor and this is likely to change the position of the country in case the planned monetary union materialises. On the prospects for, and difficulties of, monetary integration in West Africa, see Masson and Patillo (2001b).

[44] For a more complete discussion, see Bourdet (2000), pp. 137-141.

*Table 6:* Planned foreign investment (PFI) in Cape Verde (yearly average), 1994-2000.

| | PFI ('000 US$) | Industry (in % of total PFI) | Tourism | Planned employment | Nb of PFIs | PFI / private investment |
|---|---|---|---|---|---|---|
| 1994-1996 | 28.904 | 28 | 46 | 499 | 12 | 23 % |
| 1997-2000 | 90.255 | 14 | 53 | 1,709 | 18 | 51 % |

*Note:* The shares of industry and tourism in total planned FDI do not add up to 100 percent because of FDI in other sectors.
*Source of data:* Computed from data provided by PROMEX (*Centro de Promoção Turística do Investimento e das Exportações)* and INE *(Instituto Nacional de Estatística).*

The patterns of foreign direct investment in Cape Verde since 1994 are illustrated in Table 6.[45] The real flows of FDI (Foreign Direct Investment) are overestimated because Table 6 is based on planned FDI.[46] On the other hand, focusing on planned FDI provided a better picture of the attractiveness of Cape Verde for FDI and the potential impact of FDI on the economy. With these qualifications in mind, several findings emerge from Table 6. The first is the very rapid increase in foreign investment flows between the first and second sub-periods, the volume of which tripled in value. The augmentation in the number of FDIs was less impressive, suggesting that the size of FDIs increased significantly in the meantime. The share of industry in the total value of FDI halved during the period considered, whereas that of tourism increased somewhat, accounting for about half of the total value of planned FDI in Cape Verde. This result suggests that the country's comparative advantage is stronger in tourism than in manufacturing (the largest share of industry) and was still more so in the late than in the mid-1990s. The total number of jobs planned to be created by foreign investment amounts to some 8,300, that is some 5 percent of the labour force. Quite surprisingly, in view of the shift over time in the distribution across sectors of foreign investment, the number of jobs created by each dollar invested has remained more or less the same over time (this can be illustrated by divided the employment created by the value of foreign investment, the fourth column by the

[45] The volume of foreign investment before 1994 was negligible. Between 1988 and 1993, it averaged 0.1 percent of GDP and 1.2 percent of gross fixed capital formation. The statistics are from OECD (2001) and United Nations (2000), p. 308.

first). Finally, dividing the value of planned foreign investment by private investment shows the huge (potential) impact of foreign investment on private investment in Cape Verde.

A challenge for economic policy in Cape Verde is to realise the huge potential of planned foreign investment and to transform it into realised investment. According to the estimates of the central bank (*Banco de Cabo Verde*), the volume of foreign investment realised in June 2001 amounted to only about half of the total cumulated value of planned foreign investment.[47] But it is also important to attract new foreign investment and to identify the policies (or measures) that can be adopted to strengthen the impact of foreign investment on total factor productivity. Foreign firms influence total productivity through direct and indirect channels. The direct channel occurs through the entry of foreign firms with modern technology and better marketing and managerial practices. The indirect channel stems from the so-called efficiency spillovers, that is the transfer of know-how, skills and technology from foreign to domestic firms and labour. Two factors are generally put forward to explain the size of spillovers: the existence of local competition which encourages foreign firms to bring in new technology and which improves incentives for local competitors to learn from foreign firms and, secondly, learning capabilities which facilitate the transfer of knowledge and technology.[48] The first is difficult to impinge on, at least in the short and medium term, for a country like Cape Verde with at the outset a very limited number of medium and large firms. There remains the second, where the country can encourage efficiency spillovers by increasing the levels of education and improving labour skills and domestic learning capability. Focusing on education policies is also the best way to improve labour productivity, and to retain established foreign investors or to attract new ones.[49] This is so because foreign firms' decision to invest in Cape

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[46] The figures of Table 6 should be considered with some care for another reason. They are based on detailed figures provided by PROMEX, which differ from the less detailed and cumulative figures collected by the central bank (see e.g. Banco de Cabo Verde (2001), p. 24).

[47] Ibid., p. 24.

[48] See e.g. Kokko and Blomström (1995). Note, however, that the positive impact of education and learning capabilities on productivity spillovers and growth only holds empirically when the host country has a sufficient level of educational attainment (a minimum threshold stock of human capital). On this, see Borensztein et al. (1995).

[49] Educational investment in the younger generations permitted significant increases in enrolment rates in Cape Verde during the 1990s. The primary school enrolment ratio increased from 121 percent in

Verde reflects both the cost of labour in relation to competing countries, and the productivity of labour. Human capital accumulation and improved skills are, therefore, needed to outweigh the impact of rapidly rising wages in Cape Verde on the attractiveness of the country, and to remain competitive. Presumably, the decreasing share of foreign investment in industry, of the total value of planned foreign investment (see Table 6), can be ascribed to the more rapid rise in unit cost of labour in Cape Verde than in competing countries, a rise that has not been not compensated by an increase of the same order of magnitude in labour productivity.

There is another aspect that militates in favour of measures to encourage inflows of foreign direct investment in Cape Verde. A recent change in the world economy concerns the accelerated fragmentation of production, that is the breaking up of vertically integrated production processes into various components, and the subsequent expansion of outsourcing and offshore assembly in lower cost countries.[50] The process started in sectors like the textile and clothing industry and the electronics industry, but is rapidly expanding to other sectors as well. Production fragmentation (or production sharing) has far-reaching implications for the specialisation patterns between high-wage developed and low-wage developing countries.[51] In order to start production, low-wage economies do not need to gain competency in the entire production process of a product but in only one component of production, often the more labour-intensive one. In a second stage, the countries concerned can, through investment in human and physical capital, move on to components and activities that are more human and physical capital intensive. Two other benefits of production fragmentation that are very relevant to Cape Verde concern spillovers and diversification. Production fragmentation necessitates the development and maintenance of networks of producers of various components, which facilitate the transfer of technology and technical,

1990 to 148 percent in 1998 (Figures are more than 100 because enrolment includes pupils above and pupils below the primary school age, and repeaters.) The secondary school enrolment ratio increased from 21 percent in 1990 to 55 percent in 1997. The achievement of Cape Verde with respect to secondary education is remarkable in a Sub-Saharan perspective. During the same period the secondary enrolment ratio in Sub-Saharan Africa only increased from 26 to 29 percent. There remains, however, the issue of the real quality of the investment made in secondary education in Cape Verde and its real efficiency in favouring human capital formation and in increasing labour productivity. The education statistics are from World Bank (2001).

[50] On production fragmentation, see Arndt and Kierzkowski (2001).

[51] Ibid, pp. 7-8.

administrative and marketing know-how between producers at different stages of the production process. In addition, production fragmentation encourages the diversification of exports and production activities, which *per se* is regarded as favouring longer-term growth by spreading investment risks and by increasing the stock of knowledge and productivity of human capital.[52]

## 5. Elusive Self-Sustainability

External assistance, in the form of official aid and private remittances, has played a central role in the history of Cape Verde since independence in 1975. Official aid increased rapidly during the first decade following independence and amounted to some 40 percent of GDP in the 1980s. It has since decreased and accounts for a mere 10 percent of GDP today. The reduction has occurred concomitantly with a shift in the distribution of official aid with greater emphasis put on infrastructure and human capital formation. The stream of private remittances from the diaspora communities all over the world has followed an opposite path and increased significantly after the late 1980s, lessening the negative impact on the economy of the diminution of official assistance. But private remittances from the diaspora are not a form of assistance *stricto sensu*, in that they are rather investments responding to the generous conditions granted to emigrants' savings in Cape Verde. By relaxing the domestic saving constraint, large inflows of remittances can contribute greatly to capital accumulation and growth.

More growth-oriented foreign aid and remittances have run parallel with an acceleration of economic growth in Cape Verde. During the last decade, the country has experienced a growth rate well comparable with the best performers in Sub-Saharan Africa. The growth experienced during the 1990s was rapid but not self-sustained, in the sense that the country did not finance its investment needs out of its own savings. The growth experience could, however, be considered self-sustained if the flows of remittances from emigrants are considered national savings. Sustained, in

[52] Berthélemy and Söderling (2001). Mauritius is the country that is most often used to illustrate the positive impact of production fragmentation, foreign direct investment and diversification on productivity and growth. Ibid and Subramanian and Roy (2001).

some way self-sustained but unsustainable. This is a main conclusion of this paper, which shows that the 1990s rapid growth was for the most part brought about by the transfer of labour from agriculture to other sectors with higher value added per worker, a concomitant rise in labour participation rates and increased investment to GDP ratios. In order to make growth more sustainable and take the country closer to takeoff, economic policy needs to put greater emphasis on fiscal stability and on measures that improve incentives for private investment, particularly foreign investment, and human capital accumulation. This is necessary for the high growth that has been experienced by Cape Verde during the past decade to become more than just a short-lived episode.

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ISBN: 91-586-8554-5
ISSN: 1404-031X