AID-FOR-TRADE: CASE STORY

CAPE VERDE

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Introduction

Since the early 1990s, Cape Verde has embarked on a process of structural transformation to become a market economy characterized by steady levels of growth. A successful combination of good governance, sound macroeconomic policies, external support, foreign direct investment and remittances has helped the country register one of the most impressive economic performances in Africa. The WTO accession process has played a catalytic role in this economic transformation. In 2008, Cape Verde graduated from Least Developed Country status only the second LDC to make this transition.

This case story examines how this on-going process of economic transformation has been achieved and lessons which emerge for other Small Island Development States (SIDS). Finally, the case story sounds a cautionary note that further Aid for Trade support is still needed before Cape Verde so as to ensure that this economic transformation continues in a sustained way and progress is not lost by external shocks.

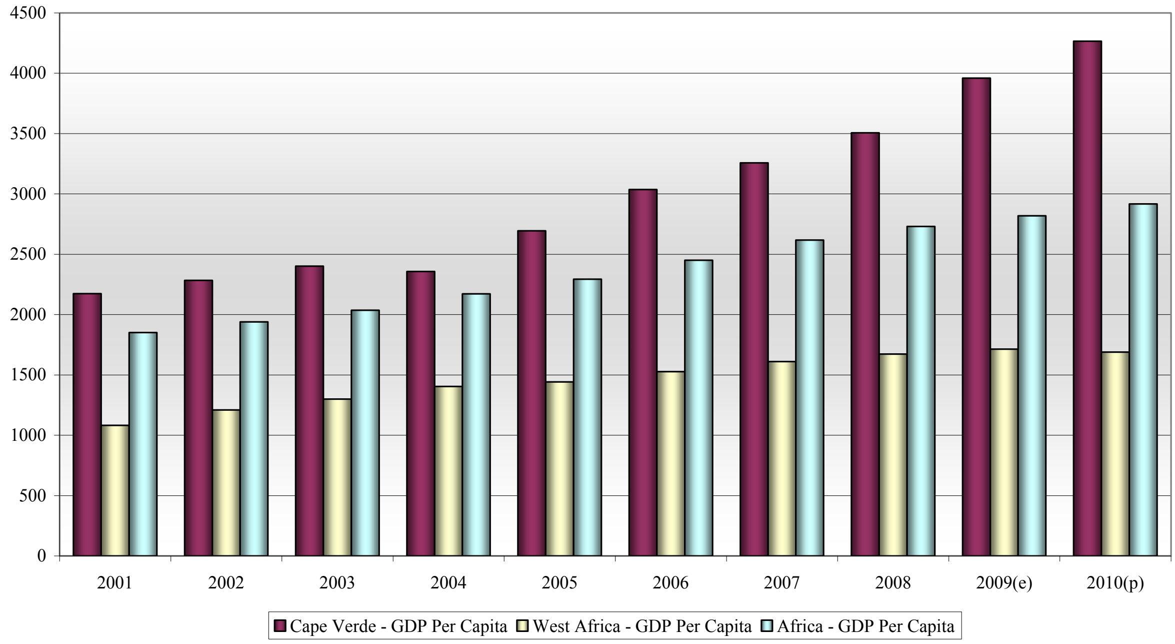
(i) Structural constraints impeding growth in Cape Verde

Cape Verde faces a number of natural structural and supply-side weaknesses as a small island developing state. An archipelago of 10 islands, Cape Verde faces particular challenges due to fragmentation of its small internal market and limited, high cost transport infrastructure. Energy generation capacity is still restricted and water scarce. Manufacturing faces inherent cost constraints and accounts for less than 20 per cent of GDP. Limited arable land and challenging climatic conditions offer unsuitable conditions for agriculture. Domestic food production is limited and the agricultural sector accounts for less than 10% of GDP, despite employing some 50% of the population. High rates of labour migration and dependence on imports, as well as on foreign aid, foreign direct investment and remittances, make Cape Verde particularly vulnerable to external shocks.

Despite unpromising fundamentals, Cape Verde has been able to chart a course of economic growth based on structural transformation, in particular by promoting its services sector. WTO accession, which Cape Verde began in 1999, has proven a useful catalyst for this reform process. Economic growth, accompanied by sound policies and political stability, has enabled significant progress on the Millennium Development Goals (MDGs). Cape Verde has already achieved 4 of the 7 MDGs – primary education for all, gender equality, reduction of infant and maternal mortality – and is one of the African countries with the best social indicators. Cape Verde's poverty index recorded a sharp decline from 36.7% in 2000 to 26.7% in 2008 and important progress has been made on the fight against HIV/AIDS, malaria and other diseases. These advancements suggest that Cape Verde is on track to achieve possibly all the MDGs by 2015.

The economic and social progress achieved allowed Cape Verde to graduate from LDC status at the beginning of 2008. It was able to satisfy for four consecutive triennial reviews the criteria of gross per capita income and human capital. While that the (economic and environmental) vulnerability indicator has not been met, this graduation holds nevertheless a special significance, as against all odds, a resource-poor country has been able to make significant progress on social and economic indicators based solely on good governance and sound economic policies.

Per Capita GDP (USD/PPP at current prices)



Source: African Economic Outlook 2010 - OECD

(ii) Services as a route to economic development

The integration of Cape Verde into the global economy is benefiting from the growing competitiveness of its services sector. Led by a flourishing tourist sector, services have become in recent years a driver of growth and development, accounting for over 70% of GDP. The consequent surge of receipts has also helped the country offset its current account deficit - the export of domestic goods is less than 7% of GDP. Trade as a percentage of GDP has grown from around 67% in 2005 to 89% in 2009. The European Union is the country's leading trade partner, with over 75% of trade.

Progress achieved by Cape Verde has been led by long-term national development strategies which have promoted economic transformation and poverty reduction, beginning in 1990. Since 2003, the Economic Transformation Strategy (ETS), has charted a plan for transformation of Cape Verde from an LDC into an emerging country. This has been operationalized by two *Growth and Poverty Reduction Strategies* (GPRS) for the period 2004-2007 and 2008-2011, which emphasise the need to promote economic growth as a means to enhance the capability of the poor to increase their incomes. In May 2008, the second GPRS was finalized which set out a "Transformation Agenda" and emphasised the need to further integrate Cape Verde in the world economy so as to reap the benefits of globalization, ensure the sustainability of social and economic development and improve the quality of life of the population.

The GPRS has five pillars:

- (i) promoting good governance, strengthening effectiveness and ensuring equity;
- (ii) developing and enhancing human capital;
- (iii) promoting competitiveness to boost economic growth and employment creation;
- (iv) improving and developing basic infrastructure, including transportation and communications, the energy sector, and the management of hydraulic resources;
- (v) improving the social protection system and guaranteeing its sustainability.

Particular focus is on 4 sectors identified in the ETS: tourism, fisheries, transport hub and offshore services. These are often accompanied by a fifth pillar, added at the end of 2008: creative and cultural industries. Overall, it is the services sector which is the main focus of the government's transformation agenda. What is significant in the choice of the sector objectives is that the priority lies with the development of export-oriented products and services, in which the country has a natural advantage due to its favourable geographical location at the crossroads of continents and a gateway to and from Africa, large coastline for the development of deep-water harbours, fisheries and tourism. While unfavourable climatic conditions may constrain agriculture, they have proven an asset for tourism.

The expansion of tourism presents the country with further opportunities for growth and diversification. So far, it has had spill-over effects on the hotel industry, the construction sector, real estate services, catering and agro-food industry. Its growth, if appropriately channelled, has the potential of dragging with it the commercial development of other sectors of the economy.

Another important resource of the Cape Verdean economy is fisheries. The sector holds an important role in terms of employment and impact on poverty, and its potential of about 36,000 tons is still underexploited. A sharp contraction of the sector was experienced between 2000 and 2003 because of sanitary restrictions imposed by the European Union. After these restrictions were lifted in 2004, fish exports picked up again, indicating that further efforts by the government to create infrastructure and comply with international standards offer one more source of sustainable growth to the country.

(iii) WTO accession – a catalyst for structural change

Cape Verde's membership of the WTO was a necessary catalyst for the country's transformation and its aspirations to become an open, globally competitive market economy. The Government of Cape Verde applied to join the WTO in November 1999 and on 23 July 2008 Cape Verde became the 153rd Member of the WTO.

The accession process promoted a deep legislative and regulatory transformation to conform to the requirements of WTO accession and Members' requests. Extensive efforts and resources went into the development of the institutional and human capacity needed to engage in the negotiations, especially amongst the staff of the key national agencies involved in external trade and foreign relations.

Compliance with WTO commitments spurred the government to review its centralized structure for public procurement, and its tax and customs code. In addition, four regulatory agencies were set up in 2004 to ensure compliance with competition rules in various economic sectors, namely: the Economic Regulatory Agency (ARE), the National Agency for Food Security (ANSA), the Regulatory and Supervisory Agency for Pharmaceutical and Food Products (ARFA), and the National Communication Agency (ANAC). The high priority given to the WTO accession process had significant implications for the country's trade policy, the upgrading of its institutional capacity and, ultimately for its economic growth and development.

Government has committed to bind industrial tariffs at rates ranging for 0% to 55%, and agricultural tariffs at average bound tariffs of 19%. It is important to note that, in spite of its service orientation, the Cape Verdean economy has given high importance to tariffs as a source of government revenue, rather than for the protection of the domestic industry and agriculture. The government has already embarked on a reform of its tax and customs system, with gradual tariff reductions. Although customs duties and other duties on international transactions have fallen, tax revenues have registered an expansion, from 20.5% of GDP in 2005 to 24.8% in 2008. This was possible because the tariff reduction was compensated by the introduction of income tax and VAT in 2004. This WTO-induced tax reform will ensure more stable government revenue and a more competitive and open market.

(iv) External support from development partners

Cape Verde has received wide-ranging support from multilateral and bilateral partners, especially to address the institutional and infrastructural constraints that hamper the country's development potential, and it is of utmost importance that such support continues in spite of the county's upgrade from the LDC's category.

(a) WTO accession support

In the framework of the WTO membership, Cape Verdean officials have participated in technical assistance activities organized by the WTO, both to facilitate the country's accession and to develop a better understanding of the WTO agreements and functioning. In addition, the Secretariat enjoyed extensive bilateral contacts with Cape Verde as part of the accession process. The table below provides an overview of the technical assistance activities undertaken by the WTO Secretariat since 2004 in which Cape Verde has participated.

Table: WTO trade-related technical assistance activities in which Cape Verde has participated

	Accession specific	General training	Total
2004	4	-	4
2005	-	5	5
2006	1 (with World Bank)	8	9
2007	1 (with World Bank)	10	11
2008	3	10	13
2009	2	17	19
2010	3 (as of October)	8 (as of October)	11
Total	14	58	**72**

Source: WTO Secretariat

In the present phase of implementation of commitments, trade-related technical assistance remains important to strengthen the institutional and human resources capacity of the Ministry of the Economy and all trade-related agencies so as to extract maximum benefit from WTO membership

In addition to assistance from the WTO, various donors and south-south partners have offered support to Cape Verde to facilitate its accession and help the country identify its needs and priorities. For example, Portugal and Brazil provided early technical assistance, including support with the translation of documents into Portuguese. In the framework of the TradeCom Facility program, the EU also funded technical assistance to guide the country in the formulation of new legislation. The project to *Support Cape Verde's Post-Accession to the World Trade Organisation* covered issues of customs, TRIPS, TBT, legislative drafting and market access on goods. The main objective was to strengthen the capacity of the Ministry of Economy, Growth and Competitiveness, and prepare the private sector to understand the new trade regime. Another EU project has addressed *Customs Reform in Cape Verde in response to WTO Obligations and Commitments*. The specific objective of the project was to increase the degree of compliance of the Cape Verdean customs system with WTO rules and obligations.

(b) External support to promote structural transformation

OECD data show that most external support in the aid categories classed as Aid for Trade has been directed to improving the port, airport, and road infrastructure to cater for the increased transit of merchandise, passengers and cargo. Funds have been directed by the government to support its strategy to improve the infrastructure and telecommunication system, expand four international airports and upgrade all the ports to international level. The upgrading of the transport facilities goes hand in hand with the expansion and establishment of high-capacity storage facilities. An important level of funding has also been directed since 2008 to the energy sector, which plays an important supportive role for the expansion of economic activities in the country.

Table : Support to Cape Verde in Aid-for-Trade related sectors - Total by sector - 2002-2008
(Source: OECD)

US$ million (constant prices)

	2002	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Transport & Storage	40.8	4.18	3.76	170.91	22.77	75.34	107.75
Communications	0.12	0.12	1.25	1.88	1.77	1.11	0.06
Energy	0.37	0.19	..	0.02	..	0.21	51.4
Banking & Financial Services	0.82	19.42	0.17	7.94	0.23	1.69	1.82
Business & Other Services	0.89	1.48	0.07	28	0.53	0.28	0.66
Agriculture	4.06	3.59	1.08	15.86	0.92	2.05	5.87
Forestry	..	0.16	..	..	..	..	..
Fishing	5.38	0.48	1.03	0.48	1.2	3.65	2.25
Industry	1.07	1.11	0.02	0.43	0.55	0.74	0.57
Mineral Resources & Mining	0.53	0.32	0.2	0.11	0.06	..	0.04
Trade Policies & Regulations	0.48	0.6	0.02	1.05	0.12	0.16	0.35
Tourism	0.19	0.28	0.5	0.01	0.11	0.56	0.12
TOTAL	54.71	31.93	8.1	226.69	28.26	85.79	170.89

Democratic governance, sound economic policymaking and the government's good management of aid inflows and external debt has sustained donors' confidence. Cape Verde has prudently managed its external debt and, according to an IMF-World Bank debt sustainability analysis, the risk of debt distress in Cape Verde remains low. The Government has been able to sustain public debt by managing its economic and financial policies. External and domestic debt stocks were 41.5% and 15.85% of GDP respectively at the end of 2008, while external debt servicing only absorbed 4.8% of exports of goods and services.

The wise management of its finances has encouraged a constant flow of ODA into Cape Verde over the years. Development aid has traditionally played an important role in Cape Verde, reaching US$ 219 million in 2008 and providing the country with a level of ODA per capita among the highest in Africa. Among bilateral partners, the main grant providers to Cape Verde are the Luxemburg and the USA, as well as Portugal, Spain, Japan, China, Brazil, and the main concessional loan providers Portugal, China (a particular case as its loans have been partly converted in grants), Spain, Brazil, France, Austria, while in the multilateral field the main grant providers are the EU and the UN One System, and the main loan providers are the ADB, The World Bank, the Arab funds (BADEA; OPEC F.; Saudi F.; Abu Dhabi F.; Kuwait F….), .

As a result of a longstanding program of public finance and budgetary reform supported mainly by the Netherlands, the EU and the World Bank, the part of budget in the ODA granted to Cape Verde has increased in the past years to be secured in around 25% of ODA. The provision of budget support to Cape Verde and implementation of measures attached to it is followed-up by a Budget Support Group (BSG) created in 2005 with the cooperation of the Netherlands, the World Bank and the European Union, and subsequently joined by the African Development Bank, Austria, Spain and Portugal. Its purpose is to align and harmonize donor budget support around Cape Verde's Growth and Poverty Reduction Strategy.

Since 2007, the European Union has established a Special Partnership Agreement (SPA) with Cape Verde. The SPA, which ultimately offers access to the European internal market, is designed to promote activities to reduce Cape Verde's structural vulnerabilities and support, in security and stability, its transformation and growth as well as its regional integration. Cape Verde has also secured funding from the United States under the Millennium Challenge Account, which aims at contributing to the transformation of the Cape Verdean economy from aid-dependent to sustainable, private-sector led.

Sound economic management, sustained donor support for the government's economic programme and structural transformation have promoted positive developments in private investment in Cape Verde. Net inflows of foreign direct investment have been growing increasing consistently. From 1.6% of GDP in 2001, foreign direct investment reached 13.8% of GDP in 2008. In 2007, the growth of inflows of FDI surpassed aid assistance received by Cape Verde. These results have been achieved thanks to renewed efforts to reduce the administrative barriers to investment, improve the business climate and increase the flows and quality of FDIs in manufacturing and tourism. It is especially in the services sector that FDIs have played an important role contributing significantly to GDP growth. Also in 2007, the fast growing tourism sector generated more revenue for the first time than immigrants' remittances. If these trends can be sustained, Cape Verde should be progressively able to move away from its aid and remittance dependency.

(v) Sustaining the Cape Verde success story

A combination of good economic management and sustained external support has helped Cape Verde address many of its development constraints. WTO accession and the graduation from LDC status have been landmark achievements for the country, but they also pose new challenges and opportunities for the country.

Cape Verde has a roadmap to complete full implementation of the WTO agreements by January 2018 This implementation period will allow Cape Verde to adjust gradually to the new policy framework without offsetting its economic stability. The Trade Department has identified a number of thematic areas for its work in support of this roadmap, including:

- Implementation and monitoring of the working plan with WTO,
- Strengthening capacities for trade negotiations,
- Minimize the challenges and costs of insularity,
- Reduce the cost of setting up a business,
- Strengthening the institutional capacity for regional integration,
- Getting benefits from membership with ECOWAS,
- Review of the opportunities of preferential market access schemes such as AGOA, Canadian Programme, etc...,
- Revision of the legal framework for the free trade zone and other institutional arrangements such as the Industrial Parks and the International Fair of Cape Verde,
- Revision and publication of the Commercial law.

Continued external support will be necessary for the full implementation of these commitments. One concern among the Cape Verde authorities is that its graduation from LDC status may lead to a phasing out of development aid in the coming years. In view of this risk, in 2006 the government and its development partners created a Transition Support Group to encourage a smooth transition for Cape Verde that does not threaten the progress already achieved. In parallel, the government has been pursing since 2006 a programme backed by an IMF Economic Policy Support Instrument (PSI), aimed at assisting the Government to reduce macroeconomic risks, resist external shocks and prepare for the long term decline of concessional aid.

Cape Verde will also need to invest more into strengthening its private sector. One paradox of its development path is the poor performance with regard to business environment. While the country has registered high economic and social performance, the World Bank Doing Business indicators (DBR) scores Cape Verde for business climate as falling short of the average of sub-Saharan Africa and lagging considerably behind the most performing countries of the continent. The latest DBR, which ranks Cape Verde 132nd for 2011 from 142nd in 2010, shows that Cape Verde is recently improving in that field.

(vi) Conclusions

Cape Verde is undergoing a deep economic transformation supported by a successful collaboration between the government, its international partners and foreign and domestic investors. WTO membership has been – and continues to be – an important driver of economic reforms and liberalization of the economy and can help the country be internationally more competitive and achieve stable economic growth.

Assistance in Aid for Trade and related sectors has been key in supporting the government in its programme of economic reform and transformation. It remains important in addressing the underlying trade-related constraints and creating the favourable conditions for economic growth which will reduce long-term aid dependency. Key to this process is domestic (including remittances) and foreign direct investment. It is noteworthy in this regard that investment outstripped aid in 2007 – a process which needs to be further encouraged.

Cape Verde's success in spite of its resource poor endowment and narrow productive base offers interesting lessons for other Small Island Development States (SIDS), not least in how important it is to use the WTO accession process as a catalyst for economic reform. Cape Verde’s case story shows that it is possible for a resource-poor country to achieve high levels of growth based on good governance and a solid developmental partnership – but that this partnership needs to continue for progress to be sustained and consolidated.